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**MIDDLESEX UNIVERSITY**

**EFFECTIVE BUSINESS AND PROFESSIONAL  
PRACTICES IN FRANCHISING**

**MARTIN MENDELSON  
D. PROF**

**JULY 1999**

P1025982

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## ESTABLISHING AN INTERNATIONAL REPUTATION

My first contact with franchising involved advising a foreign franchise company which was entering the UK market. This would be a most unlikely introduction to franchising for any lawyer nowadays. I was also fortunate in that the company which had consulted me had become one of the pioneers of franchising in the USA. Its founder Bill Rosenberg had been material in creating the International Franchise Association. This gave me an exposure in the US market place which was strengthened when I became the managing director of their operations in the UK with the additional grandiose title of Area Vice President - Europe.

My involvement in that company (Dunkin Donuts) gave me three valuable insights into franchising

- As I was involved at managerial level I received a good grounding in the basic business concept and development and understanding of the dynamics of the personal relationships which are a key component of the development of a successful franchise system
- I learned about the issues confronting a franchise company seeking to open in another country not merely as a lawyer but also as a business person
- I learned what was involved in establishing and marketing a franchise operation in the UK market place.

That said as I look back I find it difficult to put my finger on how I first became well known internationally. I would suggest that it was a combination of the association with Dunkin Donuts and the later availability of "The Guide to Franchising". At that time so far as franchising was concerned internationally was basically the USA. The development of cross border franchising activity was then in its infancy.

Later on everyone would look to the USA for role models and since that was the only market place worth considering it suited me to become well known there.

By the time the 1970's started I was in touch with the two leading franchise lawyers in the USA - professional relationships which blossomed into personal friendships lasting to this day.

In 1972 the UK government was carrying the Fair Trading Bill (which became the Fair Trading Act 1973) through parliament. During the course of its passage there was a High Court decision involving a "Pyramid Selling Scheme" which the Judge characterised as "a fraud of a grave and far reaching nature".



The government added a Part to the Bill dealing with Pyramid Selling Schemes which would require the introduction of regulations.

There was no British Franchise Association at that time to provide a focal point for lobbying but I was approached by the Treasury Solicitor acting for the DTI in the litigation for help as they believed I might have some experience or knowledge of such schemes. In fact I did have information on file relating to the way in which such schemes had been dealt with in the USA which I was able to provide.

The way in which the proposed legislation was expressed was difficult to follow but it was clear that it could pose problems for certain types of franchising structures including master franchising and area master franchise arrangements. I was consulted by the US lawyers, whom I knew, who were Counsel to the International Franchise Association (The American Franchisors' Association) for assistance in the lobbying of the DTI in which they were engaging to ensure that foreign franchisors entering the UK market would not be prevented from using their franchised business structures. In the event we were able to secure what was needed in the light of the methods used at the time.

With the introduction of other methods the law proved to be too restrictive. This resulted in my having discussions with the DTI for a lengthy period from around 1980 to date in an attempt to have the law made more accommodating for our clients from abroad. The result was the Trading Schemes Act 1996 which despite many anomalies does enable the various different methods to be used subject to compliance with laws which for the larger type business are sufficiently accommodating. The existence of the Fair Trading Act 1973 enabled me to lecture and write about its effect to and for the international franchising community. Indeed some former commonwealth countries copied the provisions in the Fair Trading act and the regulations made pursuant to its provisions. I was asked to give expert evidence in a case in South Africa on applicability of the law to a particular trading scheme.

However I have run ahead of myself in terms of the chronology but that is somewhat inevitable as very often one finds that many of the activities in which one becomes involved carry forward and run in parallel with other activities.

I found that the combination of writing, lecturing, word of mouth by clients and the contacts which I was making had led to my name becoming well known around the world.

I was contacted by many organisations to give lectures. For example I was asked to attend a residential course on franchising in Zurich in 1972. This in itself lead to me meeting other practitioners and business people from other countries which added to the pool of people who were aware of my existence and skills. I must confess that I was somewhat surprised to find how well known I had become by the early 1970's.

One of my clients who was a franchise consultant told me of a visit he made to the Middle East (Dubai I believe) and found my book in the bookcase of the person he visited.

I also tend to believe that the fact that I was the only person known to be involved in franchising in the UK assisted by providing a focal point for those who wanted to be active in the UK market whether they were indigenous or foreign. The next development of significance was the formation in 1977 of the British Franchise Association which provided a focal point for franchising for the domestic market place. It was also to become the focal point for contact with other franchise associations.

In January 1978 I went to the annual convention of the International Franchise Association in Miami. This became an annual pilgrimage for me and I have attended every annual convention of the International Franchise Association since then making 22 in all up to and including 1999.

I was for many years the only foreign lawyer attending these conventions apart in the early days some from Canada. It was not until the last 10 years that foreign delegates grew in numbers with much of that growth in the last 5 years.

The 1978 convention was a great success for me. I met a number of business people and became accepted as part of the franchise community. I laid the foundations of associations with a number of companies with whom I would work in the future. I also met the leaders of the legal professional community who were then evident in the USA and Canada. I was assisted in introductions to the franchise community by the two general counsel for the IFA with whom I had worked in the lobbying efforts in relation to the Fair Trading Act. I had also met one of them in 1972 in Zurich when we both spoke on the same programme. If I may be permitted to digress - these two lawyers who have been close friends for many years are now in partnership with each other having merged their practices. My younger son who settled in Chicago is now in partnership with them although he does not practice in franchising law.

My timing proved to be more effective than I thought it would be as I picked up some significant business; in particular there was a Canadian client wishing to enter the UK market which provided me with a significant amount of business which paid not only for this first visit but also for the next one; that was regardless of other business and the degree of exposure which I received. The decision to attend that convention was to prove to be the best step which I could have taken. Not only had I been able to secure business of some significance but I had laid the foundations for the future and had become well known to the leaders of the U.S. franchise community many of whom would be taking their franchises abroad and to the UK and Europe. I found out later that my attendance had made a far greater impact than I had appreciated - many of those whom I had met were impressed that I had taken the trouble to attend their conference.

It was clear that the 1950's and 1960's had seen the explosive growth of franchising in the USA. I believed that there would be similar explosive growth in international franchising in the future. My strategy was to lay the foundations for the future by becoming well known around the world to those who would be able to refer work to or to use my firm for their legal requirements. There were a number of ways in which this could be achieved.

- continued attendance at the IFA annual conventions
- I started to attend the legal symposium held by the IFA each year in Washington DC in May commencing in 1980. This brought me into contact with the lawyers who practised in franchising in the USA which broadened my range of contacts and the knowledge which others had of my involvement. Many of those who attend are in house counsel for whose companies my firm now acts. Over the course of time I have been invited on many occasions to speak at these symposia. This also enhanced an awareness of my existence and hopefully my skills. Over the years these symposia have been attended by increasing numbers of lawyers from other countries and I was able to establish relationships which have proved useful over the years.
- to become known to the franchise associations from around the world. This has been a successful strategy to which I shall refer below.
- I joined the American Bar Association's Forum Committee on Franchising which also held annual meetings. I have been invited to speak at many of their meetings and have written a number of articles for the Franchise Law Journal which it publishes. In particular in 1987 I was invited to share, with a member of the European Commissioner for Competition's Cabinet, a workshop on the proposed EC block regulation for categories on franchise agreement. As the only lawyer in private practice involved in negotiating an individual exemption for a franchise company and involved in the lobbying exercise I was in some demand for lecturing on the topic.
- to continue to write and lecture; the writing not only to include books but also articles to be published in journals and publications around the world. The booklets published in the UK "How to Evaluate a Franchise" and "How to franchise your Business" in 1980 and 1981 respectively were widely circulated not only in the UK but also abroad.

I was retained as "of counsel" by the Belmont European Community Law Office in Brussels to be available to advise their clients on franchising. This also extended my exposure through different avenues.

I decided in 1980 to join the International Bar Association (IBA) which had no exposure to franchising. The IBA is organised into sections - A section on Business Law; a section on General Practice; a section on Energy Law. Each section is comprised of various committees with individual legal specialities eg. committee on competition law; committee on intellectual property law. I contacted the Executive Director of the IBA to suggest that a committee on International Franchising should be constituted. I was asked to write a paper to demonstrate why franchising needed a separate committee and could not be accommodated within the existing Committee Structure. I did this and at its meeting in New Delhi in the autumn of 1982, the Council of the Section on Business Law authorised its Chairman to establish a committee on International Franchising for a two year trial period if I could convince him it was worth the effort. I met him in November 1982 in New York and managed to convince him and I was appointed Chairman of the Committee. He made it a condition of the survival of the Committee after the trial period that we should have at least 100 members. We actually achieved that in the first year. The committee now has some 800+ members and is highly regarded within the IBA. The term of office of a committee Chairman is 4 years so I had a limited time to establish the committee as a feature of the franchising world. I appointed as my Vice-Chairman one of the two lawyers I had met in 1972 when lobbying about the Fair Trading Act 1973.

The first conference at which we were able to organise a programme was held in Toronto in 1983. The programme was entitled "International Franchising - An Overview" and included the following topics:-

- An introduction to Franchising
- Franchising: Trade Mark Practitioners' Perspective
- Character Merchandising
- Regulation on Franchising in the United States: Implications for International Franchising
- Legislation and Regulations Affecting Franchising in Canada - An Overview
- Franchising in Latin America
- Focus on Franchising in the Asia/Pacific Region: Joint Venture, Regulation of Investment, Tax
- Franchising in Europe - United Kingdom
- Franchising in Europe - EEC
- Franchising in Europe - France
- Franchising in Europe - Germany

Arrangements had been made with a publisher for the papers to be produced in a book to which I contributed and which I edited.

The programme was well attended as the novelty of the subject was well recognised and there was much interest.

After the success of this programme it occurred to me that it would make sense to hold a one day seminar in Washington in May to follow the IFA Legal Symposium. My reasoning was that a significant number of those attending the Legal Symposium might be likely to stay on for the extra day, particularly as International Franchising was likely to feature in their practices and their "in house" legal work.

My Vice-Chairman and I discussed the ideas with the IFA at their annual convention in 1984 with a view to holding the first seminar in the May of that year. The IFA agreed and following the approval given by the IBA the programme was organised. We were both delighted and astonished to find that 93 delegates pre-registered and with "walk-in" registrations that attendance topped 100. The seminar made money which also pleased the IFA and the IBA.

That one day seminar has proved to be a great success and I have been pleased to attend the 16 seminars which have been held each year since then. The average registrations have exceeded 100 and in 1998 there were approximately 130 delegates.

The activities of the committee have increased in range over the years and it has been established as the principal international legal committee on franchising.

In 1986 the Australian Government introduced a draft "Franchise Agreements Bill". By then I had become sufficiently well known for a representative of the Federal Attorney General's office to visit me when in London to canvass my views. This proposed development was of such significance that I determined that this was something with which we (the IBA Committee) should deal. I had discussions with the Franchisors' Association of Australia (FAA) and the IBA about presenting a joint seminar about the draft Bill. The interest from the IBA point of view was that it had many members in the southern hemisphere and it would send them the right message if a seminar could be held in Australia, particularly one on a narrow area of law. The IBA did not want to lose money. The FAA were able to organise sponsorship to ensure that the seminar would at least break even. In the end we had two seminars both of which I chaired. I also led one of the sessions. My vice chairman also led one of the sessions. The two seminars were held in Melbourne and Sydney. The first in Melbourne was attended by the Attorney-General of the State of Victoria who spoke at the seminar the second in Sydney was attended by the Deputy Prime Minister and Federal Attorney General who also spoke. My colleague and I were also entertained to lunch to meet the Attorney General of the State of New South Wales.

The seminars were a great success and as part of the lobbying activities of the FAA they remarkably achieved the abandonment of the proposal - there was only one speaker who was a proponent of the legislation. Everyone else including franchisees were opposed to what was an ill conceived and badly drafted legislative proposal.

By this time my standing in International Franchising had been established to the point where I was regarded (by others I would add) as among the top two lawyers in the world in this field - the other was my vice chairman in the International franchising Committee of the IBA. I have managed to maintain that status and so far as I can ascertain I am regarded also as one of the leading authorities on the business aspects also. Recently there was published an International Who's Who of Franchise lawyers whose publisher told me I was the most mentioned lawyer by my peers - so I must be doing something right.

When publicity was given in Australia to the seminars and the fact that I would be participating I received an invitation to visit Auckland and speak at a seminar to be organised specifically for the purpose. To my surprise I found over 200 delegates at the seminar. In 1986 there had been a decision by the European Court of Justice in relation to the application of European Community Competition Law to franchise agreements. I was told there was interest in the subject in New Zealand as there was a new competition law and that members of the competition law authority were in attendance hoping to hear about the European approach.

The visit to Australia, preceded by Auckland and followed by a round table workshop at which I spoke in Chicago to an invited group of franchisors on the way home about the Australian proposals and the European developments turned out to be a demanding trip but it enabled me to meet a wide cross section of the Australian Franchise Community and to strengthen my reputation in the Southern hemisphere. (See below).

I have continued to play an active role in speaking at meetings at the International Franchising Committees and have been consulted by its successive chairman on various issues as a sort of "elder statesman". Indeed in 1997 at its May meeting in Washington I was invited to speak at lunchtime about my thirty three years in franchising and the changes which have taken place over that period of time.

To return to Australia my relationship with the FAA was well established by the seminar programmes and I was asked by them to comment, for the purpose of assisting their lobbying efforts, on a new bill which the government introduced and which was subsequently abandoned.

My involvement with events in Australia continued. In 1990 I was invited to visit again to lecture at four venues, Auckland (the Australian and New Zealand Franchising Associations had merged only to demerge in 1997), Melbourne, Sydney and Brisbane.

Australia has a very large and active franchise community by then and the levels of interest and debate reflected the high level of local expertise which were available. In Brisbane in addition to the seminar I was asked to address a breakfast meeting of the Brisbane Chapter of the Franchise Association. I also held

a meeting with the Federal Minister for Small Business - and about my views on franchise regulation. I was interviewed by New Zealand radio when in Auckland and by a local radio station in Brisbane.

In 1993 I was in Australia for an IBA Conference and met with a lawyer appointed by the government to prepare a report and make recommendations about franchise regulation who wished to canvass my views.

Then in 1989, the FAA approached me for permission to publish Australian versions of "How to Evaluate a Franchise" and "How to Franchise Your Business", which I gave. Australian editions of both books were published in 1990, 1991, 1993, 1994, 1996 and 1998 owing to the heavy demand for both. I have been told that some 6,000 copies of "How to Evaluate a Franchise" are sold in Australia every year, which means that close on 50,000 have been sold in Australia alone. I understand that the BFA sell 6,000-8,000 Franchisee Packs every year (these include "How to Evaluate a Franchise"). When one takes the numbers sold in other countries and the countries where local language versions are available, the total sales of that book could well be in excess of 250,000.

"How to Franchise Your Business" has also been sold in many countries around the world, as well as forming part of the BFA Franchise Pack. I would estimate local sales of that book could well be approaching the same numbers as those achieved by "How to Evaluate a Franchise".

These considerable sales around the world and the demand for translations have led to my name becoming very well known.

These books have now been published, apart from English, in Chinese, Spanish, Czech, Polish, Hungarian, French and Indonesian.

"How to Evaluate a Franchise" in its Australian version was the only publication authorised for use by the Australian Code voluntary regulatory body established under governmental authority. It was a requirement of the Code that a copy of the book be delivered to every prospective franchisee to assist in an evaluation of the franchise proposition.

In following the Australian and IBA developments, I have moved ahead of 1986, the year in which I visited Australia. Earlier in that year, I was invited to South Africa to conduct a seminar on "How to Franchise Your Business". The seminar was scheduled to last all day - 6 hours in all. This was the first of such seminars to be held in South Africa by their Franchise Association. I was to be the only speaker. The demand was considerable and the audience numbered around 120 delegates. The interest at the seminar was very encouraging and audience participation high, so high in fact that when the 6 hours were up I had not been able to cover all the material. The organisers were able to ensure that the facilities could

continue to be available and as the delegates wished to continue I continued on for another 2 hours to complete the topics. Substantially, the whole audience remained for the extra period.

After the seminar, there was a reception at which an interesting incident occurred which I thought carried a message for us all. I was chatting with the managing director of a franchise company when we were approached by one of the delegates. He asked if he could pose a question to the managing director and said that in asking it he intended no offence to me. His question was very simply and apt - "You have been in franchising for 15 years. Why on earth did you come to this seminar, what could you learn?" The reply was also simple - "50% I knew, 40% reminded me of what I once knew but had forgotten and 10% was new." I am sure that his equation applies to many of us - I am certainly conscious of the fact that when I speak or write I often later think of issues I could or should have mentioned but which escaped my mind at the time. Given the level of audience participation, it would be inevitable that issues would be raised which could take us into uncharted territory. In addition, many of the audience had little or no knowledge or experience of franchising and were prepared to challenge what many of us took for granted.

I received further invitations to South Africa and gave more seminars in Johannesburg and Cape Town in 1988 and 1989.

In 1991, I was again invited and by then the franchise community had grown and there was much more activity. We decided on three seminars and the franchise association wanted to run them concurrently with a franchise exhibition and their annual banquet and annual awards ceremony.

The three seminars were, first, "How to Franchise Your Business", which was conducted using a role playing method. The attendance exceeded 100 and was a great success with all but 3 of the delegates participating with questions; second, "A Franchise Agreement Round table", which was limited to 12 franchise companies whose agreements I was sent in advance. I discussed issues which arose from those agreements without identifying the company involved in any particular case. One should remember that in those days, South Africa was somewhat isolated and franchise law and business practice developed without any knowledge of what was happening elsewhere, except to the extent that I had dealt with developments in my previous lectures. I found much to criticise and also unwitting unethical practices. I was informed later by the Association that all the companies which attended that session had within 3 months amended their agreements to reflect what they had learned; third "A Legal Workshop" which was limited to 12 attorneys. The purpose of this was to have a wide ranging discussion of legal issues involved in franchising so that South African attorneys would know how they were dealt with elsewhere so that they could provide better informed advice to their clients.



The seminars were a success and I was somewhat astonished to find that at the awards ceremony I was honoured with the South African Franchise Personality of the Year (1991) award as a gesture of thanks for my contribution to franchising development in South Africa.

I was also interviewed about franchising on a radio chat show for approximately 20 minutes.

I subsequently visited South Africa in 1993 and 1997. On the latter occasion, I was made an Honorary Member of the South African Franchise Association.

The South African Franchise Association also published copies of my seminar papers in booklet form and also produced versions of "How to Franchise Your Business" and "How to Evaluate a Franchise".

I was interviewed for TV and radio (in addition to the chat show) on various visits to South Africa.

While on the subject of TV and radio interviews, it is probably convenient to mention the following other interviews in or for foreign radio audiences.

BBC World Service

Irish Radio

Hungarian TV

Innumerable US radio business talk shows

So far as the latter are concerned, very often the interviews are conducted live by telephone. I recall one particular interview where I was contacted by telephone and we were constantly interrupted by commercial breaks. It was somewhat disconcerting, to say the least, to hear an "ad" intervene as I was just beginning my reply to a question.

I have also been interviewed for TV in England (BBC, ITV and Channel 4).

It was in 1985 when I was approached by a law journal publisher who suggested that the time had come to produce a law journal about franchising in the UK. I asked him if he wanted to publish more than one issue a year. He was surprised at the reply and said there must be at least 4. I pointed out that there was insufficient legal activity in the UK at that time to justify that level of material. I asked him if he would be interested in producing an international franchise law journal since:

- there was no such publication anywhere in the world and
- there would be plenty of material to be published from around the world.

He immediately agreed and The Journal of International Franchising and Distribution Law was born as a quarterly publication. The first publisher was Frank Cass. He sold his law journals to Tolley's some 4-5 years ago and in 1998 Tolley's transferred the title to the worldwide law publisher Kluwer who have been relaunched the journal in 1999 as its International Journal of Franchising and Distribution Law.

The launch of the journal in 1986 with me as its editor (and I might add a frequent contributor) further enhanced my standing in the world of international franchising. Not only is it significant in reputation terms to be the editor of a legal journal, it builds one's name in front of the international legal community in a very effective way, particularly as publishers tend to promote their journals on the back of the reputation of the editor's standing in the field. It is, therefore, an effective way of finding someone else to "blow one's trumpet". The journal has become very well known and professional colleagues whom I meet refer to it as "your journal" as if I had proprietary rights, such is its effectiveness.

Kluwer had approached me some time before it took over the publication of the journal, requesting me to write for them. I have some difficulty as I have published so much in relation to franchising it is difficult to find subject matter which does not conflict with what I have previously written. We decided that I should organise and edit an "International Encyclopaedia of Franchising". This is a large project which will never end. It will be published in loose leaf format with regular updates. It is expected to cover 80-100 countries in due course. We already have 25 country contributors working on it. The first issue with 6 countries was published in January 1999. In view of the magnitude of the book, I have invited a co-editor to join me from the USA firm which is the largest in this field. It is now becoming a joint project and it will be easy for someone else in my firm to take it over when I am ready to retire.

It was in the mid-1980's that I realised that if I was to be able to market my services in a more widespread manner to the international market I was setting my sights too low to concentrate only on being available and experienced in the UK. I had noticed the ability of law firms in the USA to represent their clients in all 50 states of the Union, even if not members of the local bar. This was achieved by acquiring a knowledge of the legal differences between the States and by using local law firms with whom they customarily dealt when required. I could see no reason why we could not do something similar in Europe so that we could offer a "one-stop" service. I would then be able to market my legal services to foreign franchise companies on the basis that we could service their needs throughout Europe. I, therefore, formed an informal group of lawyers - now called "The Euro Franchise Lawyers Group" - which had one member from each of the then 12 member states of the European Community. As the European Community grew into the European Union, we expanded our membership and now have 19 countries represented. The success of this operation was in no small measure due to the fact that the members were either advisors

to their national franchise association or otherwise regarded as the leading lawyers practising in the field in their respective countries.

Fortified by the creation of this group, I made sure that from my many visits to places far and wide around the world, I met and established good relations with not only franchise associations but also with the leading local practitioners so that I laid the foundations for:

- referrals from the Associations if their members wished to enter into UK and/or European markets
- referrals from the lawyers if their clients wished to enter the UK and/or European markets
- the provision of local information sources which would be responsible and reliable and
- the availability of quality local legal advice for my clients.

I found franchise associations, particularly those in countries which were just commencing their build up in franchising, to be in need of educational material and teaching. I made it a point to assist them wherever I could on a non-profit basis. I did not charge lecture fees or for advice I gave, and continue to give them, and I allowed them to reproduce my books locally, with translations if necessary, without charging royalties. This provided the Association with a ready source of income from seminars and from publications as well as having access to me for advice and guidance. In this way, I helped franchise associations in the following countries:

The UK<sup>3</sup>

Indonesia<sup>3</sup>

Poland<sup>3</sup>

Czech Republic<sup>3</sup>

Hong Kong<sup>3</sup>

Sweden<sup>2</sup>

Denmark<sup>2</sup>

Russia<sup>3</sup>

Ireland<sup>2</sup>

Canada<sup>2</sup>

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1 Books  
2 Lectures  
3 Both

USA<sup>2</sup> (The International Franchise Association whose UK representative I was for a few years until they discontinued that programme)

Australia<sup>3</sup>

New Zealand<sup>3</sup>

Brazil<sup>3</sup>

Argentina<sup>3</sup>

South Africa<sup>3</sup>

Germany<sup>2</sup>

Spain<sup>3</sup>

Apart from being well known in these countries, my wide connections and the wealth of the relationships has made it possible for me to secure access to quality information and advice which others do not have available to them.

I have now developed a service which enables us to offer international clients the equivalent of an outsourced "in-house" law department and at a price which makes a lot of sense for them. We now have clients from many other countries who use this service including Australia, South Africa, the USA, France, Germany, Spain and Portugal.

Indeed, in the last 2-3 years we have advised clients in entering approximately 75 different markets around the world; some of the destinations have been quite exotic. The recent economic upheavals in the Far East and Russia have resulted in we and our clients having to devise innovative solutions to the problem of how to deal with maintaining supplies of products with fast devaluing local currencies and how best to cope with the insolvency of foreign companies in these regions. Since our clients had been made aware of the high risks involved in entering some of these markets, it is possible to factor their returns to allow for it as well as providing insurance for the insolvency risks.

It was in 1996 that I decided that I needed to address two problems with which my clients were becoming increasingly involved. The first was the inability to obtain objective authoritative and ethical advice about franchising wherever in the world they wanted to go (including in the UK). Many profess to have abilities and experience which they do not possess. The second was the inability to find "partners" in other parts of the world to take up franchises.

I decided that the solution would be to combine forces with an international consultancy group of repute to form a global franchise consultancy. We decided that it could not be one of the then big 6 accountancy firms as they were all forming their own law practices. The natural choice was Horwath International, a combined international grouping of accountants, hospitality consultants and management consultants

with over 300 offices in 80 countries. We approached them and they were already aware of my position in the market, liked the idea and agreed. We signed a joint venture in November 1996 and in 1997 I ran two training courses for would-be consultants. We started appointing consultants at the end of 1997 and there are now 20 so far with more in the pipeline.

We have also established a register which contains details of franchisors seeking franchisees and/or master franchise partners and details of prospective franchisees and master franchise partners seeking franchisors so that we can try to match them.

At this point, it is of interest to pause and summarise the key developments in the establishment of my international development:

- The use of my various publications
- The widespread lecturing in foreign countries (see schedule attached taken from my Professional review)
- My initiative in persuading the IBA to establish a committee on international franchising
- My initiative in persuading Frank Cass to publish its Journal of International Franchising and Distribution Law
- Establishing my relationships with national franchise associations
- The creation of the Euro Franchise Lawyers Group
- The establishment of widespread working and friendly relationships with franchise lawyers worldwide.

There are some remaining aspects to my international activities with which I shall deal:

- Publications in which I have been involved other than those already referred to
- My work with and for various international bodies
- My work with Queen Mary College and City University in relation to residential international franchising summer schools

- “How to Franchise Internationally”.

I shall deal with each in turn.

### **PUBLICATIONS IN WHICH I HAVE BEEN INVOLVED OTHER THAN THOSE REFERRED TO ABOVE**

The earliest which I can recall was a publication entitled "Survey of Foreign Laws and regulations Affecting International Franchising". The first edition was published in 1982 by the American Bar Association under the general ownership of Philip F Zeidman, a US Attorney friend of mine. He consulted me on the basic format setting out the nature and scope of the information to be submitted by contributors. I contributed the UK section as well as that on EC (as it then was) competition law affecting franchising throughout the European Community.

A second edition of this work was published in 1990 and again Phil Zeidman consulted me about an update of the basic format and I was able to make a number of suggestions based upon the issues I had found in practice to be those which arose most frequently.

This publication was the first which covered this subject matter and the first edition dealt with 20 countries, expanded to 23 countries in the second edition.

“The Canadian Franchise Guide” was published in loose leaf format many years ago and I was asked by its editor to write a section dealing with franchising in the UK. I have updated that on a regular basis since and am now in the course of preparing an update.

“Practical Financial Management” is a publication prepared in loose leaf format primarily for the accountancy profession. I was asked to prepare a section dealing with franchising in the UK. I have updated this on a regular basis and am now in the course of preparing an update.

In 1996, a publication entitled “European Union Law after Maastricht “ was published by Kluwer Law International under the editorship of Ralph H. Foesom, Ralph B. Lake and Ved P. Nanda. I was asked to make a contribution about franchising in the EC. A second edition was subsequently published to which I made an updated contribution.

I also contributed a chapter on "The Block Exemption Regulation for Franchise Agreements" to a loose leaf volume entitled "European Economic Community Law" published by Business Laws Inc. in the USA.

## **MY WORK WITH AND FOR VARIOUS INTERNATIONAL BODIES**

### **UNIDROIT**

This is an intergovernmental organisation based in Rome which has approximately 60 subscribing countries as members. Its function is to identify laws which relate to international activities and to create a standard code which can be adopted by its member states. Unidroit, at the request of its developing world members, initiated an investigation into international franchising. In reality the problem was not international franchising but how those member states coped with franchising in their domestic laws given that the concept was novel to them and that they perceived that this would create legal problems within their respective jurisdictions.

Unidroit appointed a study group comprising individuals selected by Unidroit as having the requisite experience and representatives of governments and selected franchise associations. I had the honour of being selected by Unidroit and appointed by them to the study group. The study group met and considered that an international uniform code was inappropriate but recommended the preparation of a "Guide to International Master Franchise Agreements" which would explain franchising and assist those in the developing world in understanding the issues where international franchising was involved. The Guide was to be prepared on the basis that it explained and set out the issues with the arguments for and against which could be expected to arise in the course of negotiations but it was not to take a position on what was the recommended outcome. The reason for this latter requirement was of course that each of these types of contract are individually negotiated and that there was not necessarily any "position" which would be right in any or every case.

The Guide was the result of drafting by members of the Group of individual chapters which were then debated at great length at a series of plenary meetings. I was asked to contribute 4 chapters (approx 20% of the Guide) as well as to participate in the debates. Draft versions of the Guide were distributed for comment and there were two final drafting meetings in Rome and Washington each attended by two of the Study Group. I was in attendance at the Rome meeting. The Guide was published in August 1998 in English and French language versions.

I have been asked by Unidroit to continue to be involved in the work of the Study Group in preparing a draft of pre-contractual disclosure law which can be adopted by the member states which wish to do so. The objective would ensure so far as practicable that if states wish to adopt such a law they would use the

Unidroit format and enable franchise companies to know that their disclosure documentation could be used universally. This task is just beginning.

## **OECD**

I was approached by the OECD which is based in Paris for assistance in the preparation of a study on franchising and competition law. I was asked to read a draft of the study and to comment which I did in. I was also asked to visit their offices in Paris to discuss the issues which I had revised. The outcome was a substantial re-write of the explanatory commercial and legal chapters. The problems arose because OECD had asked a professor of law to write these chapters who had no knowledge of franchising. His approach had been to study the cases and written material about distribution a systems and extrapolate them as if they readily translated into franchising. This was a fallacy since although franchising contains elements of traditional distribution it is so far removed from it in its operational aspects that the approach adopted could not work. Examples of the differences are:

- A traditional distributor trades under his own name - a franchisee does not
- a traditional distributor will invariably carry a range of products of his own choice - a franchisee will not
- the traditional distributor may well carry ranges of products made by different producers which compete with each other - franchisees rarely do that
- the traditional distributor runs his business the way he chooses; his supplier does not intervene - a franchisee runs his business in accordance with the system laid down by the franchisor
- a traditional distributor buys and resells for profit and does not pay anything to his suppliers except the purchase price - a franchisee also buys and resells for profit but also pays a franchisor a fee for a range of support services which the traditional distributor does not receive
- In competition law terms the approaches of each type of business method to market sharing is different.

I was also asked by the OECD to visit some of the Central and Eastern European states in transit from a managed to a free market economy. The countries involved were Hungary Poland and the then Czechoslovakia. The OECD had been asked to assist and advise them particularly about their anti-



monopoly laws (competition laws) and franchising, which earlier they appreciated, could provide much of what they lacked in terms of know-how training and experience.

With a U.S. colleague, Phil Zeidman, I visited Hungary Poland and Czechoslovakia at the OECD's request. When we addressed senior government officers from a variety of departments as well as leading business people and the senior staff of anti-monopoly officer about franchising and the contribution which it could make to their economies.

I later visited Poland with the OECD to conduct a seminar for the Anti-monopoly office on how their law applied to franchising and how they could approach the issues which were likely to arise. I also advised them in relation to the first franchising case which they had to consider. Later on one of their staff spent two weeks in my office in London learning about competition law. We also arranged for her to spend time with the Office of Fair Trading.

### ILO/UNDP

I was originally approached by the ILO to prepare a study for them on how franchising could be used in developing economies to generate new business and job creation.

During the course of the work on this study the ILO were approached by Indonesia who wanted assistance in franchising. They had some franchising in their country but recognised that they needed a franchise association as a focal point. They also wanted some guidance on how to stimulate the growth by indigenous businesses through franchising.

I was asked to visit Jakarta to advise on these two issues.

I was in Jakarta for two weeks during which time I met with government officials from the Finance Ministry and Department of Trade, bankers, lawyers and franchisors. I also met with a Business School which had prepared a study of franchising which I was asked to review.

After meeting with the group of franchisors I prepared a statement of objectives for a franchisee association and drafted a constitution for its establishment. I also produced a suggested programme of activities. While I was in Jakarta the Indonesian Franchise Association was formed and my suggestions and drafts adopted.



The Business School study was somewhat flawed as they had no idea what they were really involved in and seemed geared to establishing their school together with an Australian consultant as a Franchise Consultancy. This meant that the study lacked objectivity. They had also adopted criteria which meant that they could never correctly assess the size of the existing market place. For example they excluded from their franchise headcount:

- foreign franchises
- sub-franchisors

as well as many indigenous systems which did not meet a very narrow and atypical definition of franchising which they had prepared.

It was easy to appreciate that the whole business, governmental and judicial system in Indonesia was corrupt and thrived on graft. They really did not want objective advice they really wanted to be advised about how to introduce a regulatory regime requiring registration and permits so that underpaid officials could demand bribes in accordance with local custom. I am afraid I disappointed them.

They could not have been too disappointed since I was invited to visit a second time to advise on whether their legal system was franchise friendly and if not what could be done to make it so. I was also asked to advise further about how to expand knowledge and accelerate growth of business through franchising.

There were a number of legal issues which I was able to identify for them but I do not know whether any have been implemented.

I also devised a scheme for a government funded Franchise Resource Centre to work with the Franchise Association to spread the word about franchising. It was a 3-5 year plan with the Association gradually taking over as the numbers of franchisors increased and the activities generated a sufficient flow of income to replace the government funding.

### **The UK Know-How Fund**

This fund was established by the government to fund the transfer of know-how to the former Soviet bloc. The Secretary of State at the DTI on a visit to Moscow was reported to be extolling the virtue of small business for the Russian economy. I wrote to him suggesting that one route to achieving this objective would be franchising. He referred my letter to the appropriate officials who were interested in my suggestion. There then followed some three years of being flipped around like a "ping-pong ball" as

departments and officials switched responsibilities. Ultimately, following discussions with the Russian government about my proposals the Know-How Fund retained me to do a report

- on the laws of Russia, their impact on franchising and what changes or new laws were needed for franchising to thrive and
- to assess what existing indigenous businesses were suitable to be selected for pilot testing of franchising in the Russian market and how to go about it.

My Russian clients were the Federal Committee for the Promotion of Small Business. They were already in close contact with an embryonic Franchise Association whose president had made an excellent job of learning about franchising and had made visits abroad to franchise seminars and exhibitions.

In view of the official nature of our client we were able to meet with many officials and the official bodies which administered laws. We were not able to meet with the Finance Ministry since they, learning in advance about what we intended to discuss, decided that they did not wish to deal with these issues. However we had lengthy and fruitful discussions with the Patent and Trade Mark Office and the Anti-Monopoly Office (this office subsequently contacted us for further assistance) as well as the other bodies with whom we needed to speak.

Our report was extensive - for example it included a review of the Russian Civil Code and its effect on franchising. We were also able to provide a programme of activity for the franchise association which could be used to support any pilot operations. We were also able to devise a proposed method of supporting the establishment of pilot operations and subsequent franchise system development in a way which could lead to the training of lecturers in Business Schools who could develop the capacity to deliver training in future.

The report was accepted with approval by the Know-How Fund which has been engaged in discussions with the Russians about implementation.

This also resulted in my being asked to lecture in Russia on programmes organised by the International Bar Association. The Guide to Franchising was translated into Russian funded by a US Charitable Trust and over 10,000 copies of a 20,000 print were in circulation within a few months.

**My work with Queen Mary College and City University Business School in relation to residential international franchising summer schools**

In the early 1980's, I was approached by Queen Mary College (London University) to participate in a residential international franchising summer school as part of its current summer school programme. I invited Phil Zeidman to join me and we composed a detailed and complex case study. We divided the group into teams which had to work through the study and present solutions at the end. The programme lasted for a week and was very intensive.

We were again invited to repeat the programme two years later. We used the same format which was very successful.

After I was appointed Visiting Professor at City University Business School in 1989, I suggested a joint programme with Queen Mary College but the latter did not wish to do it. Barclays Bank were prevailed upon to sponsor the programme and we set it up at CUBS. Unfortunately Phil Zeidman had to withdraw at the last minute and I had to conduct the programme myself, which was a large undertaking. However we managed to successfully conclude the programme.

As an aside I would mention that QM College asked me to help them to structure a half subject optional course on Franchising for the London University LLM degree, I have lectured regularly on that course.

## How to Franchise internationally

This was the third in a series of "How to" books which all had their origins in a series of articles in Franchise World magazine. The first edition was published in 1989 and dealt with the complete spectrum of issues from whether or not to franchise internationally - through the business issues, legal audits, methods to be used and contractual issues.

I decided in 1997 that the time had come for an update. There was more to write about, more issues had arisen and there had been a spate of regulation around the world. I also decided on re-reading the book that it could be restructured to deal with the issues in a far better way.

The revised chapter headings produced the following outcome:

Chapter 1	-	Taking the decision to franchise internationally
Chapter 2	-	Business and Legal Audits
Chapter 3	-	Structuring the arrangements
Chapter 4	-	Direct franchising and Development Agreements
Chapter 5	-	Master franchise agreements
Chapter 6	-	Financial considerations
Chapter 7	-	Franchise Regulation

The resulting work is a substantial re-organisation and re-write with twice the text of the first edition. I believe it will greatly enhance the book's usefulness for its readers. It reflects the lessons I have learned over the years and I have tried to keep it as user friendly as possible. I was pleased that the man who first introduced me to franchising in 1964 when he retained me to be managing director of Dunkin Donuts in the UK was gracious enough to write the foreword to the second edition which I set out below.

"I found this book by Martin Mendelsohn an absolutely essential guide to the do's and don'ts of International Franchising. I believe Martin is uniquely qualified to this task. In addition to his role as a solicitor, Martin assumed responsibility in the 1960's as Managing Director for Dunkin' Donuts in its early entry into the UK marketplace. Martin was present at the beginning of franchising in Europe and for the past 35 years has been a shaper, educator, and participant in its growth. His advice is founded on years of experience and success that few, if any, can match.

**ROBERT R. ROSENBERG**  
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Tel Aviv		
Paris		

## FRANCHISING - WHAT NOW?

The last and only time when I went into print on a similar subject was in the first edition of "The Guide to Franchising" published in 1970. In a chapter entitled "Franchising in the UK - What Next?". I expressed the following views:

- A. that franchising would offer solutions to the service industries' problems in terms of manpower shortages;
- B. that it was to be expected that there would be a rapid growth rate in the UK but slower than that achieved in the USA;
- C. that relative views between the US and UK cultures on how savings should be invested would result in a slower take-up of franchises by UK business people;
- D. that the internal growth rate in the UK may be in:
  - smaller less expensive franchises
  - franchises which lend themselves to absentee ownership, ie with investors;
- E. areas for growth would include:
  - food
  - leisure
  - specialist automotive aftercare;
- F. the dishonest elements which had then abused franchising needed to be confronted with a strong trade association;
- G. if the industry would properly organise itself it would undoubtedly make rapid strides towards achieving respectability.



In a book<sup>3</sup> published in 1972 some of my suggestions were criticised. The author in particular criticised the views set out above in paragraphs C and D.

In revisiting the views expressed so long ago (since the book was written in 1969 these views were formulated 30 years ago) I believe I did not do too badly. Certainly the perspective now is better than it was when the 1972 book was published.

The service industry is the largest sector offering franchises. The UK growth rate even at its peak has been slower than that in the USA. There has been a slower take up by franchisees in the UK. Franchisors to whom I speak all find franchisee recruitment a problem.

The growth rate in smaller less expensive franchises has been considerable to the point that after the BFA was formed it was describing them as "Job Franchises" which is something of a misnomer. There have been many investment individuals or groups as franchisees or combinations of investors and those working in the franchise particularly in higher cost franchise systems. It should be remembered that in 1970 there were no banks offering franchisee finance; that was then some 11 years in the future.

The three areas identified for growth did provide (and still do) much of the activity. One could have added "Business to Business" and businesses catering for the domestic/home market but these categories were not so clearly identified in those days.

In 1977 the British Franchise Association was formed and has achieved much for the benefit of franchising and its acceptability as a respectable economic force.

The author of the 1972 work may have been justified in making his criticisms but had he waited a bit longer ....

One might say that with all that has happened since 1970; the growth of franchising; its globalisation; the maturity of systems; the knowledge now available, it is much easier now to look ahead with more precision and confidence. On the contrary, it is probably more difficult now than it was then.

Why is that so? In 1970 the market was small and under developed - it was only then possible to base one's views on narrow horizons. My 1970 views were contrasting the USA with the UK. Now franchising can be found in at least 140 countries and there is a network of systems crossing many national boundaries,

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<sup>3</sup> Franchising and the Total Distribution System - Dov Israeli published by Longman

moving in all directions. There is undoubtedly a minority of these 140 countries whose franchisors are exporters but the list is growing all the time as is the number of countries embracing franchising.

I propose first to list some of my experiences and conclusions before looking ahead since the forward view is dependant on an analysis of the past and present.

The levels of ignorance in some developing world countries is distorting the market with such countries as China, Indonesia, Malaysia, Albania, Romania, South Korea and Russian adopting laws many of which are hostile to franchise development.

There are surprising levels of ignorance wherever franchising is to be found. When this ignorance is exploited by opportunism it can create a lethal combination.

I have visited many franchise exhibitions in many parts of the world. Some of the exhibition organisers take care to ensure that only properly structured and tried and tested systems can participate. Some are not so selective. I would cite as an example the so called International Franchise Expo invariably held each year in the USA. Each year every exhibitor, whether or not it has an established profitable home base, invite interest from would be foreign franchisee prospects. They do this because they reckon that the large initial fee payments they expect to receive will provide the working capital they are lacking. I can recall one particular case where we were asked to advise a would be master franchisee. We examined the US disclosure document which had been prepared. It showed that this Franchisor company which claimed to be in twenty countries was barely profitable in its US operations and did not have the capital available to guarantee continued operations.

Apart from that there were a significant minority of domestic and national franchise offerings by companies which had glossy brochures and impressive marketing materials but had never operated their own pilot operation to prove that their ideas worked in practice. Indeed, they had no working example to show anyone. A feature of each successive expo is that, perhaps not unexpectedly, few of these offerings appear the next year.

Apart from the worrying transient nature of these dubious offers it is a feature of franchising that many of those who appear to be franchisors or offering franchises are spurious, testing the market or are incapable of delivering what they describe. This tends to give a misleading impression of what is the market and whether those who doubtfully enter the market as "franchisors" have abandoned it.

Franchising started its initial push for growth in the USA in the 1950's and 1960's. Although international growth started in the 1960's it did not reach the same proportions as did the US domestic growth until the latter half of the 1980's and the 1990's. Now there is a considerable move into transnational expansion.

My work in the field of franchising has brought me increasing exposure to international franchising. Over the years I have advised (and still do) many of what may be described as the household names in franchising. Many of these companies might be expected to have accumulated sufficient know-how and experience to have addressed the relevant issues and to have coped with them. That is not often the case despite the fact that many of them are US based with extensive in-house legal teams and outside advisors. Recent examples include:

1. Large multi-national company with a presence in at least 80 countries who consulted me to review their international franchise agreements. The advice as always requires a knowledge of the business issues which arise in practice. As the discussion progressed, I was surprised to hear the reaction to my comments which broadly speaking were along the lines of "if we only had had that provision in the agreement we would not have had problems in country X, or Y or Z etc."
2. Large multi-national company with a similar presence including a significant US representation. I was asked to review the contracts and report which I did in writing. The response was that I had raised a number of issues, of which they were not aware, with which they intended to deal in all the markets in which they operated including the USA.
3. Large international company with a presence in 50+ countries where I found that there was no coherent international contractual approach. We had to prepare a set of documentation to replace multiple approaches which were deficient.
4. Large company with two brands each operating in 25-30 countries for over 10 years which realised its contractual arrangements were deficient. This required a restructuring of the business and legal arrangements.

I could continue in the same vein. The fact of the matter is that I am exposed regularly to similar situations some before preparing advice which is necessary to review the existing domestic and international business and contractual arrangements.

One of the most difficult problems for the would be multi-national Franchisor is finding suitable companies or individuals in the targeted territories. The better known and well established franchise companies are less likely to be confronted with this problem - their problem may be who not to choose.

For the unlucky majority there are many pitfalls. There are a number of ways in which contacts can be made but they are often "hit and miss". There is a dearth of ethical and able franchise business consultancy advice available around the world. To cope with this hiatus I have arranged for my firm to enter into a joint venture with the international consultancy and accounting umbrella organisation, Horwath International. The joint venture has two functions:

- the establishment of a global franchise consultancy providing trained ethical consultants;
- the establishment of a Register of franchisors seeking franchisees and prospective franchisees seeking franchisors.

A problem affecting franchising development in various countries and not limited as many may think to the developing world, is a dearth of good quality education. This is essential if ethical responsible franchising is to develop. There are some educational establishments, particularly in the USA which offer courses. Many of those courses are run by those with an academic background and do not involve those with front line experience. Judging by their "academic" papers on the subject of franchising, many of them do not demonstrate an understanding of the underlying business and personal relationships. Franchising is essentially concerned with practical issues. I for one do not recognise franchising as I know it in many of these papers. Nor have I found that some highly publicised UK papers reflect the experience of my clientele or draw the conclusions which one finds to be the actual reality. There is a golden opportunity for the Middlesex University Business School to take the lead in global franchise education as I believe its Dean, Professor Kirby, recognises.

There is a thirst for knowledge and I know from the demand for my books to be made available worldwide and in translations. I also receive many requests from franchise associations and conference organisers from around the world to speak at seminars or to conduct ad hoc round tables, workshops or other educational sessions.

It might be thought that the list of business categories to be franchised has grown endlessly but this is not the case. If one looks at the various lists published in "The Guide to Franchising" and its various editions the core categories have remained unchanged. The breadth of some categories has broadened as one might expect reflecting a general broadening regardless of whether or not franchising is involved. Franchising as a method of marketing goods and services will always "piggy-back" the development in the overall market place. New technologies bring new challenges but those challenges are to the ingenuity of those who have to find ways of applying the principles of franchising to the way in which the new technology operates in the market place. The Internet has produced challenges as providers and others involved in

this “jungle warfare” seek to benefit from what franchising has to offer. Intranet and extranet techniques are being offered to franchise systems as improved paperless methods of communications. Superficially attractive schemes can have their drawbacks as an American Franchisor discovered when a US Court held that by using electronic methods it had put its Operational Manual into the public domain and it could not therefore protect it from others wishing to cash in on its availability.

One of the hidden legal pitfalls for franchising has always been the way in which laws framed for other purposes can have an impact on franchising practices.

Over the years it is clear that the basic principles upon which franchising was based have not changed. What has improved is our greater knowledge of the way in which these principles can be put to better use. I find in practice that when confronted with problems very few franchisors return to basic principles and seek a solution by working forward. What they do is virtually to apply “elastoplast” to the problem and hope it will cure itself. By a series of such actions the Franchisor distances himself from where he should be.

We must not lose sight of the fact that the world has changed so much in the forty years during which franchising has developed. Looking back to the 1950's/1960's we were in the era when photocopying machines were emerging - liquids needed to be used. Xerox just came through sometime in the 60's (late so far as I recall). No fax, not even telex, no courier services (many of which are now franchised) - a letter posted in the City of London was invariably delivered 2 to 3 hours later - no mobile phones - in fact, wrong numbers and crossed lines were “par for the course”. The every day use of computers was some way in the future. It was possible to travel by liner between foreign countries - not very useful for the modern business man - but flying was then very much a minority pursuit.

Franchising now as mentioned above is found in 140 plus countries. There are probably in excess of 15,000 systems and 1.5m to 2m franchised outlets. I say probably but no-one knows the true figures. Unless companies which franchise identify themselves as franchisors many are not included in the figures which are published from time to time. There is also double counting as many systems operate in a number of countries.

In expanding into different country markets there are a number of legal and business issues which need to be addressed<sup>4</sup>. As may be expected from the above comments franchisors have coped with such issues or in many cases not coped with them depending on their astuteness and the quality of the advice they have

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<sup>4</sup> See Chapter 2 “How to Franchise Internationally” 2nd Edition, Martin Mendelsohn, published by Franchise World Publications,

taken. As is clear from the above comments, quality advice is scarce and even when offered if not palatable is not accepted and acted upon.

In some instances one may say that many franchisors have succeeded despite themselves and their deficiencies. The relative novelty of franchising and its attractiveness to prospective franchisees has carried it along. A greater degree of awareness in more countries of the pitfalls may well make continued progress a more difficult task in the future than it has been. Some years ago I attended a symposium in the USA organised by the International Franchise Association. I attended a workshop on international franchising and heard a former Franchisor company CEO then turned consultant state "I advise franchisors with the ambition to explore foreign markets to go to South America rather than Europe. The Europeans understand franchising and the issues better and will not pay so much, particularly up front, as you will be able to obtain in South America". Perhaps correct but questionable ethics. Now however, South America has come of age.

In looking to the future I am mindful that it will be very different from the past since apart from the changes in the market place there are other factors at work which will distort the market and make life more difficult for franchisors - one does not mind this so far as the bad franchisors are concerned; the problem is that the good and responsible franchisors will be affected regardless of whether they deserve to be.

There are the following headings under which I would expect the issues to arise. They are in no particular order (except alphabetical) and on the whole they are in all probability inter-dependant.

- Education
- (Business) Development
- Globalisation
- Legislation
- Professionalism

I shall discuss each in turn.

## Education

There is a vast amount of work needed to ensure that proper educational guidance is available where needed. In fact, it is needed even in what may be regarded as mature franchise markets. Apart from the USA, there are few markets in which there have been lateral movements of significance by senior/middle management in franchise companies. The result is that there are a great number of "one company" managers who believe that good or bad or even specific their company methods are the only and best methods for running a franchise. So far as the immature markets are concerned, education is the key to establishing properly structured franchise systems and having them staffed by those who understand what properly needs to be done. In addition there needs to be made available information to the business community at large about franchising its advantages and disadvantages so that business people can make informed decisions about whether to franchise or to become franchisees.

I have been retained to advise governments in what may be described as developing world countries. In all cases education was a vital gap which needed to be filled. Unfortunately, those most willing and available are invariably those with an eye to a quick killing rather than those who are likely to be there in the medium to long term. The "con-men" always arrive first; introduce bad practice based upon ignorance and disappear, with the fruits, leaving problems behind. It is only by ensuring that education is available where it is needed and of the right standard that the assistance which many countries need can be provided.

It is when one considers two markets in which franchising is barely to be found, namely China and India, and the vast scope available there for the development and growth of systems that one can appreciate the need to ensure that they are taught properly. China has already introduced a "trial" law which seeks to introduce "principles of voluntariness, fairness, compensation, good faith and standardisation" into the market place. The law is clearly deficient and in some respects could benefit from a greater level of understanding of the issues which underline the need for education or governments and legislations (See more on this issue below - Legislation).

A proper and thorough knowledge base will be more important as the years pass by.

## (Business) Developments

The world of business is very different today from what it was in 1964 when I first became aware of franchising. Franchising is not insulated from such developments - indeed it has thrived upon them.

I referred above to the fact that when franchising started out there were primitive photocopying machines, followed by Xerox, by telex, by fax etc. One business which has thrived on the back of those advances as well as those in the development of printing processes, is that of speedy print. There are two significant franchise systems in the UK, Kall Kwik and Prontaprint, as well as thousands of independents which offer these services as well as a range of complimentary services to domestic and business customers.

The photographic processing advances have spawned 1 hour printing services which have sprung up not only in chemist shops and other shops but also in franchise systems offering a limited number of printing and developing options.

Many years ago a company called ServiceMaster was started in the USA. Originally it offered a "mothball" fabric protection service. This was followed by a service which offered in situ cleaning of fitted carpets, upholstery and curtains. So revolutionary was this concept that it met considerable resistance from manufacturers who did not believe that the service would be good for their products. Attitudes have changed and ServiceMaster on the back of its franchising systems has grown into one of the worlds leading services companies with some 7 or 8 brands under its belt.

In the 1970's when faced with a damaging recession - people will delay cleaning carpets, upholstery and curtains in a recession in favour of necessities - and failing franchisees ServiceMaster was able to introduce a damage restoration service - people still have fires and natural disasters in a recession - which was welcomed by the insurance community and not only saved the franchise network but also has ever since provided them with a growing source of business.

As it happens even while I write this paper there has been an announcement of a proposal to build an hotel in space. The promoters are approaching British Airways and Hilton Hotels for assistance. Both companies already franchise. Will the first space hotel be a Hilton franchisee?

Computer and Internet technology companies are viewing franchising as a method of expanding services. As mentioned above many website designers are selling services to franchise companies to establish "intranet" (ie. a closed circuit network) for their system communications and Internet for the marketing of their franchise opportunities. The latter is quite a challenge given the differing legal requirements around the world (see below).

The fundamental value of franchising to those operators is the speed of an international "roll out" programme offered by franchising which is essential if they are to obtain even the basic minimum international capabilities to stay ahead of the competition.



One can always be certain that as new developments arise someone somewhere will franchise them.

### Globalisation

The franchise systems which were the first to take advantage of global opportunities were those which sought to care for their domestic customers wherever in the world they travelled. Early international development was then seen in the car rental and hotel industries. The most diligent other early internationalists were found in the fast food industry and automotive after care.

The early pioneers had their problems which included a failure to recognise that they were trying to establish their business in a different market place where there were different laws, business practices and culture. Even to this day, many companies fail to recognise these factors.

What any would be international Franchisor must understand is that he is not merely establishing a franchise in the largest territory, he is exporting a business there. It is a business start up as well as a franchise launch. To achieve the latter it is necessary to be able to satisfy the market that the basic business unit will be sufficiently successful in the target territory to justify the investment. In other words, whether one is developing in the domestic or the international market the issue is the same.

Globalisation of franchise systems is certainly a way forward when the domestic market is substantially covered. Some companies do not work that way and some do not even establish a successful domestic business before thinking international.

For a company to consider global expansion there are some sensible pre-requisites.

1. The company must establish a profitable domestic business.
2. The company must have financial resources to devote to international operations. Spending starts on "day one", income will inevitably take time to come on stream.
3. The company must be able to divert manpower resources from its domestic operations to international operations. The temptation, otherwise to neglect international in order to cope with problems in domestic operations, is too great and counter productive.

4. The company's management must be patient and carefully selective in choosing those with whom to do business in the target territory. They must never reach the point where they cannot afford or risk saying "No" when it is the right answer.
5. When the company has prepared its financial budgets, allocated manpower resources and estimated the time span it should multiply all by a factor of two to three since that is likely to be more accurate and objective than what would normally be an optimistic best case approach.

The achievement of globalisation is likely to become more difficult rather than easier. This is despite the fact that there is more guidance available. The recent economic upsets in Russia and the Far East both (particularly the latter) popular destinations for franchising has had an adverse effect not only on growth and ambition but also on existing operations. The "gung ho" attitude of many in the Far East to the acquisition of master franchisees where money was no object will be replaced by a cynical realism although one must be mindful of the fact that those who have suffered from a recession are normally the first to line up for more punishment when markets recover. One need only look at the banks' behaviour over the years to appreciate that.

If anything one should expect international expansion to grow more slowly although given the much higher Franchisor base around the world that will be more apparent in percentage rather than volume terms.

### Legislation

One of the factors which will affect global growth is the growing level of legislation specifically focussed on franchising.

Many developing world governments are anxious for franchising to develop in their countries for the training, business and job development which it brings with it. However, they are afflicted with common misconceptions:

- Franchising - its there - we must do something about it - let's pass a law. The reality is that in most countries if franchising is not prohibited, and it would be an accident if it were, it is usually quite possible within existing legal frameworks. That has proved to be the case in most countries even those with a civil code systems where contractual provisions are implied according to the nature of the transaction. No civil code (other than Russia and Romania) has a franchise code.

- Franchising started in the USA. They have widespread legislation and regulation therefore it is essential we follow that lead. That is simplistically naive thinking. In the USA there are more laws regulating them than in most countries. The franchise laws are on the whole, an overkill and many of them were not supported by evidence of the levels of abuse which justified their enactment. No government can assume that the laws of another country should apply in their country without making a proper study of the abuses which may exist there and whether or not they are sufficient to justify legislation or regulation. An examination of existing laws is also necessary to ascertain whether adequate remedies exist, to cope with perceived or actual abuses, which is usually the case.
- A concern that unless there is legislation no-one will understand what franchising is! Judging by the, so far thankfully, small amount of legislation in countries whose governments think that way, neither do those who legislate.

Thoughtless unjustified and ignorance based laws are likely to increase creating more hurdles, not only from developing world countries who do not know any better but from developed countries who should.

For many years there were franchise specific laws only in the USA and the Province of Alberta in Canada. Recently there have been laws introduced in:

- France
- Spain
- Brazil
- Mexico
- Indonesia
- The Republic of Korea
- The Russian Federation
- Australia
- Romania

- Albania
- China

In Italy two bills have been presented to Parliament but not by the government. There is also a Franchise bill before Parliament in Malaysia.

A summary of these laws and the Italian proposal will be found in Appendix A to this paper which is an update on the laws reported on in "How to Franchise Internationally".

As will be seen from the comments many of the provisions are difficult to reconcile with franchising. Even the Australians who should know a lot better have contrived, in meeting a political agenda, to create a monster.

The small volume of ill considered laws and their imposition of politically motivated interference with business methods can only have a profound inhibiting effect on franchise development, particularly if the trickle turns into a flood.

The International Institute for the Unification of Private Law (UNIDROIT) which is an intergovernmental body has produced a "Guide to International Master Franchise Arrangements" which was published in 1998. The introduction to that Guide is reproduced in Appendix B to this paper and explains UNIDROIT's approach to international franchising from the perspective of a possible law maker.

The problems which are becoming apparent and which in many countries are based on lack of knowledge underline the views I express above (see education) about the need to educate. Hopefully, if those who advise those who legislate have a proper grasp of the nature of franchising if legislation is prohibited there must be a better chance that it will be balanced and realistic in the achievement of legislative objectives.

### Professionalism

Franchising is particularly dependent upon the right infrastructure being in place. The infrastructure must be right in each franchise system. The franchise community as a whole needs the right infrastructure in its domestic as well as the international market places. The quality of the various levels and infrastructure will depend upon the professionalism of those who create and provide it.

Looking first at individual franchise systems. There is a need for staff trained in what franchising is and how it should be applied to the particular business. The range of services to be provided must be identified and the relationship between Franchisor and franchisee understood. Many systems have grown up on a trial and error basis. Those which make fewest errors succeed, those who make more may or may not succeed. The rest do so with more expense and problems than they should have experienced. Those who do not cause themselves and unfortunate franchisees more grief than was necessary. One experiences far more cases of incompetence than fraud although the net effect is often the same. It may come as a surprise to some to learn that many companies either consider good advice too expensive or (in the case of larger companies) are too arrogant to accept that franchising is not easy and requires a learning curve, that the learning curve should precede the commencement of business is too difficult for them to accept.

I am able to make these observations since in our practice we are often consulted by some of these companies when they are confronted with their problems.

In a sense their ignorance is understandable although their belief that despite it they can succeed is not. There is a difficulty in finding ethical objective and experienced advisors. Many of those who offer consultancy services are those who were formerly employed by franchisors and took up consultancy when their jobs ended. That does not guarantee that the best advice will be available and it is not. Some companies employ those who have worked for franchise companies but with an imperfect knowledge do not appreciate that the skills they need are not within the work experience of those whom they recruit.

The lack of professionalism is not confined to those who offer consultancy services. The competitive pressure on the professions have led to many professional (lawyers and accountants) professing skills which they do not possess which does mean that the positive inputs which they should be providing and which their clients believe they are receiving are not being delivered.

One can only hope that with the passage of time these standards will improve but there is a long way to go.

In some companies the pressure for growth is such that they recruit franchisees without ensuring that the supporting infrastructure is created in their organisation to sustain these franchisees. This creates a pool of franchisees dissatisfied with the Franchisor's services and is detrimental to the long term health of the system.

The Banking community in the UK provides very professional services to the franchise community and has taken the trouble to ensure continuity of skilled and experienced managers to cover the franchising market place.

In the international arena the infrastructure is very important but those with the skills to provide it are limited in numbers although there is no shortage of volunteers.

The successful sustained growth of franchising systems is dependant upon the existence of an infrastructure with professionals who can provide skills in:

- management
- consultancy
- legal and taxation and
- accountancy

It is no coincidence that apart from the in-house expertise in many large international franchise companies (and that often depends on outside advisors as I know from my clientele) there are few professional firms which can provide the global guidance which franchisors need as they seek to expand across national boundaries.

The opportunity which this presents to my profession has resulted in my firm developing "an out sourced in-house law department" capability where we advise on and co-ordinate our clients legal requirements in regions or across the world. This has been very successful and to illustrate the paucity of supply in the market place there is only one other law firm (in the USA) which can and does compete with this across the world. We number clients using this service from all continents including the USA.

Where will this necessary professionalism come from. It can only come from the provision of educational facilities which would enable the necessary knowledge to be acquired.

Business people and their advisors must understand that successful franchising requires acquired knowledge and not instinct. There is a great need for knowledge everywhere, not only where franchising has not existed so far, but even where it is reckoned to be mature in its market place. There will always be new challenges which will require creative solutions and they best come from those who have taken the trouble to master their subject.

## Albania

Albania has adopted a Chapter in its Civil Code entitled "Franchising". The Chapter defines franchising in this way. "The Franchising contract contains an account of continuous obligations by which independent enterprises are obliged to stimulate and develop together the commerce and competition of services in application of separate obligations".

One would imagine that something of the meaning is lost in this translation.

The Code has nine articles of which the first is the definition. The others are:

- The obligations of the franchisor; which are to pass on knowledge and "immaterial rights" (?) to protect the "programme of obligations and support the franchisee"
- There is a two way fiduciary relationship in respect of the provision of pre-contractual information with an indemnity for breach. The innocent party to the negotiations can claim expenses if the other intentionally does not allow a contract to be formed
- The contract has to be in writing and contain all obligations and details of the programme
- If the contract does not specify a term or if the term is for more than 10 years either party can withdraw on one years notice. The parties can agree to renewals in the contract
- A franchisee can be restrained from competing for up to one year after termination but the franchisee may be entitled to compensation
- The franchisor can be held liable if unable to deliver the rights and know-how on which the programme is based
- The franchisor has a right to claim damages arising from the franchisee's breach of contract or failure to sufficiently apply the franchise programme
- In the event of a breach (fundamental breach probably?) that puts the trade activity at risk the contracting party has the right of withdrawal regardless of the term.

This Code is, as will be seen, a superficial treatment of the subject matter and has the potential to create difficulties for franchise systems.

## Alberta, Canada

The original law relating to franchising dates back to the early 1980s when a disclosure and registration regime was introduced. The regulatory body which administered the legislation was the Alberta Securities Commission Agency to whom a form of disclosure document had to be submitted for approval. On approval being given and the franchise registered the franchisor could then offer its franchises for sale in Alberta.

This law was amended in 1995 when the pre-contractual disclosure requirement was continued but the requirement for registration with the review by the Alberta Securities Agency Commission ceased.

The disclosure document must be received by the prospective franchisee at least 14 days before signing any agreement or paying any money. The document must:

- comply with the requirements of regulations which came into force on 1 November 1995 unless exempt
- contain copies of all proposed franchise agreements
- contain financial statements reports and other documents in accordance with the regulations

There are exemptions in both the statute and the regulations.

The law goes somewhat beyond disclosure and contains provisions

- imposing on both parties a duty of fair dealing in performance and enforcement
- a right for franchisees to associate with each other
- a right for the franchisee to claim damages for a misrepresentation in a disclosure document

The law also permits the Lieutenant General in Council to appoint one or more bodies to govern franchising and to provide fair dealing ensuring franchisors and franchisee with power to make regulations for their establishment.



## Australia

Australia has been flirting with franchise regulation since 1985/86 when the Federal Government issued a Franchise Agreements Bill for comment. This step which was taken in response to a decision by a Judge that the sale of a franchise was the sale of a security and then subject to the Companies Codes. This resulted in the imposition of a disclosure requirement modelled on the rules applicable to companies. This was notwithstanding that another Judge had disagreed with the first Judge's opinion. The absence of an appeal to a higher court meant that the uncertainty continued. The Franchise Agreements Bill was widely criticised by franchisors and franchisees and replaced by a redrafted Bill which was published. This was equally criticised and abandoned. The government then passed a regulation exempting franchise agreements from the Companies Codes.

There followed more pressure for regulation which resulted in the establishment of a voluntary code administered by a company established for the purpose and supported by the Government. This eventually collapsed unlike the political pressure to do something. It had been clear that the Trade Practices Act which was robustly applied by the Judges provided franchisees with adequate remedies. Indeed many judgments were given about which many observers had doubts. However this was not enough and the government recently introduced two proposed changes to the Trade Practices Act. One of the changes proposes the introduction of a prohibition against unconscionable conduct by a franchisor. The other proposes that Codes of Conduct should have the force of law. The proposals have received widespread criticism not only from the franchise community but also from independent organisations (eg. The Law Council of Australia).

So far as unconscionable conduct is concerned the proposals contain a prohibition against such conduct. In determining whether a company has engaged in unconscionable conduct the Court may have regard to:

- (a) the relative strengths of the bargaining positions of the supplier and the business consumer; and
- (b) whether, as a result of conduct engaged in by the supplier, the business consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the supplier; and
- (c) whether the business consumer was able to understand any documents relating to the supply or possible supply of the goods or services; and
- (d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the business consumer or a person acting on behalf of the business consumer by the supplier or

a person acting on behalf of the supplier in relation to the supply or possible supply of the goods or services; and

- (e) the amount for which, and the circumstances under which, the business consumer could have acquired identical or equivalent goods or services from a person other than the supplier; and
- (f) the extent to which the supplier's conduct towards the business consumer was consistent with the supplier's conduct in similar transactions between the supplier and other like business consumers; and
- (g) the requirements of any applicable industry code; and
- (h) the requirement of any other industry code, if the business consumer acted on the reasonable belief that the supplier would comply with that code; and
- (i) the extent to which the supplier unreasonably failed to disclose to the business consumer:
  - (i) any intended conduct of the supplier that might affect the interests of the business consumer; and
  - (ii) any risk to the business consumer arising from the supplier's intended conduct (being risks that the supplier should have foreseen would not be apparent to the business consumer); and
- (j) the extent to which the supplier was willing to negotiate the terms and conditions of any contract for supply of the goods or services with the business consumer; and
- (k) the extent to which the supplier and the business consumer acted in good faith.

The Court must not have regard to any circumstances that were not reasonably foreseeable at the time of the alleged contravention and although it may have regard to circumstance existing before the proposal becomes law but not to conduct engaged in before that date.

There is no certainty that this will become law at the time of writing but unless there is an election in Australia before it is passed or an unexpected change of heart this will become the law.

The draft code of conduct was sent for comment over the Easter 1998 holiday with an incredibly short consultation period. The criticisms were many and widespread since the draft appeared to have been prepared in a franchise "knowledge free vacuum". A further draft - slightly improved - was produced with even less time for consultation and with a prohibition on its publication. The final version of the Code was published as this was being written. Fortunately the government has been responsive to many, but not all, of the criticisms sufficient to enable the Franchise Council of Australia to be encouraged. Franchisors who are domiciled or who are based outside Australia, who only have one Master Franchise or Franchise in Australia are exempt from the Code. Despite this those seeking to do business in Australia will need to weigh up their options with great care and may conclude that there are other markets to explore with fewer obstacles before taking the undoubted risks the Australian market appears to be creating.

## **Brazil**

The law introducing a pre-contract disclosure requirement was passed on 15 December 1994.

The law does not regulate the relationship between franchisor and franchisee which continues to be governed by Brazil's Civil and Commercial Codes.

The disclosure requirements are quite extensive and include:-

- the business background and information about the franchise
- financial information including balance sheets
- what the franchisee will be expected to do
- the status of the franchisor's trade marks
- agreements with suppliers
- list of franchisees
- details of pending litigation
- investment required

The contract will also be attached to the disclosure document which must be presented to the prospective franchisee at least 10 days prior to the signing of the franchise contract or even a preliminary contract.

Failure by a franchisor to comply provides the franchisee with a right to rescind the contract obtain a refund of fees and claim damages.

## **China**

By a circular dated November 14, 1997 the Ministry of Domestic Trade promulgated "Measures for Administration of Franchise Operations" (for trial implementation).

These measures were introduced in accordance with instructions of the leaders of the State Council "with a view to standardising franchise operations and promoting the development of chain stores" and apply to franchise operations within the territory of the Peoples Republic of China.

Authorisation of the use of the name to be given to the franchise enterprise and the amount of royalties to be paid for what is described as the use of the franchise right are to be governed by existing structures.

The measures are also concerned with protecting the lawful rights and interests of both the franchisor and the franchisee.

The measures seek to introduce a level of balance by dealing with not only the franchisor but also the franchisee.

The definition of franchising is somewhat basic but given its stage of development is probably adequate. The measure is stated to be for "trial implementation" so one imagines that experience will bring improvements.

There is a basic principal in that franchising issues are to be conducted in adherence to the principles of "voluntariness, fairness, compensation, good faith and standardisation".

There are descriptions of:

- Direct franchises
- Sub-franchise (regional franchise) which seems to include multiple franchising as well as master franchising.

The measure lays down requirements to be met by both franchisors and franchisees as well establishing their respective fundamental rights and duties.

The basic requirements for the contents of franchise agreements are listed as well as the types of charges which a franchisor may make to the franchisees. These include:

- initial franchise fees
- royalties

- security deposits
- other charges for services provided by the franchisor to the franchisee

There is a requirement for a franchisor to make written disclosure to a prospective franchisee at least 10 days prior to the signing of a contract. The minimum information to be provided includes:

- the name and basic facts of the franchisor's company its business performance, business consistency of its franchise
- an investment budget for the franchise based on practice
- methods of collection of royalties and various charges
- terms and restrictions for supply of articles and goods.

Intellectual property rights are to be handled in accordance with other relevant provisions.

The measures also identify other bodies which are to be concerned in drafting policies, regulations and managing guiding planning and co-ordinating franchise operations as well as codes of conduct.

## **France**

The law focussed on licensing of trade marks subject to the licensee accepting exclusivity or quasi exclusivity and thus affecting franchising was adopted by the French parliament on 31 December 1989. The law is named Loi Doubin after the member of parliament who introduced it.

The basic law provides that prior to the execution of a contract there must be provided to the franchisee (licensee) "a document giving honest information permitting the other party to make an informed decision". The document, whose contents were to be specified in a regulation, are to include:-

- information on the franchisors business, its experience and how long established
- the market and its growth potential
- the term and renewal
- termination and conditions for the transfer of the business
- scope of exclusivity granted

The document has to be provided at least 20 days prior to the execution of the contract or the payment of any money.

The regulation followed (obviously urgency was not a consideration) on 6 April 1991 and provided that the document must contain the following information about the franchisor and its business:-

- the registered office, its legal form, the nature of its activities the identity of its management and its share capital
- its registration number on the Commercial Companies' Register or its registered number on the Register of Independent Entrepreneurs.
- the record of any trade mark registration or licences relating to their use by the licensor at the Trade Mark Registry
- the address of the bank branches which it uses (limited to 5 bank branches)
- the date of the establishment of the business its history the history of its network and all information necessary to assess its business and its management's experience. This may be limited to the preceding 5 years
- a description of the market in general and the local market and the prospects for its development
- the following details of the network:
  - a list of franchisees
  - their addresses
  - the dates of signature and renewal of agreements

This may be limited to the 50 franchisees closest to the location proposed for the prospective franchisee

- if applicable the catchment area or territory of the proposed franchisee and other franchised (licenced) establishments which are in the same area
- a description of the term of the contract and conditions for renewal, termination, assignment and exclusivity
- a description of the nature and amount of expenses and capital investment.

Non compliance is a criminal offence. The franchisee also has a range of remedies under the Civil Code.

## **Indonesia**

The Indonesia Government issued a regulation on franchising on 18 June 1997. The basic law provides a framework for pre-contract disclosure and for registration of new agreements as well as existing agreements; the former within 30 days from the date of the agreement and in the latter case within six months from the date of the regulation. Failure to register results in the revocation of the franchisee's business licence.

The implementing regulation provides more detail of the required pre-contract disclosure which must be truthful and in writing and provide information about:

- the franchisor and its business activities
- the IP rights
- the franchisee's obligations
- the franchisor's support
- the respective rights and obligations of the parties
- termination cancellation and renewal of the contract

There are other non pre-disclosure requirements

- priority has to be given to local sourcing of products and services
- the franchisor has an obligation to nurture, guide and train the franchisee
- a sub-franchisor is required to operate at least one unit

There is a peculiar provision which while permitting pan Indonesian development restricts implementation to stages with account to be taken of social and economic development in the framework of the development of small and medium sized business. The Minister of Industry and Trade will stipulate implementation provisions after consultation with the minister and heads of relevant government agencies.

## Italy

So far in Italy there is no law directly focussed on franchising. Bills have been laid before parliament but whether they will become law and if so whether the Bills will be changed is unknown.

The first Bill is the one on which the following comments were based. It was introduced on 2 March 1997.

The draft is in two parts - the first part is an explanation of the reasoning behind the Bill the second part contains the substantive provisions. Part one seeks to explain franchising without quite succeeding which is all the more worrying since part two does not offer any definition as a foundation for the regulations.

Examples without comments of some of the proposals include:

- the franchisor must have carried out experiments in the market for a minimum period of one year using a proper formula with at least one pilot unit
- the franchisor must own valid and uncontested legal rights to the exclusive use of the commercial marks
- the European Code of Ethics must be incorporated in the contract - the Operations Manual is an integral part of the contract.
- the agreement must be for a term (not less than 3 years) sufficient to allow amortization of the investment
- an assumption that exclusivity of territory is essential
- the contract must have a post term non-compete charge for at least 3 years after termination
- know how and confidential information is protectable apparently indefinitely and the franchisee is obliged to insure that this protection extends to staff and relations even after termination
- neither party can assign the contract without the consent of the others

## Korea



On 7 April 1997 the Fair Trade Commission issued a notice setting out the criteria for establishing what constitute unfair trade acts in franchising under the Korean Monopoly Regulation and Fair Trade Act.

The approach is different from those so far described. The basic principle is based upon the assertion that the nature of franchising requires a franchisor to make available the data and information which is necessary to enable a prospective franchisee to make an informed decision about whether or not to take up a franchise. Anything which a franchisor may do which may necessarily interfere with the franchisee's activities in its franchised business must be disclosed by the franchisor.

The disclosure information is based upon one party taking unfair advantage of the other as provided in the Monopoly Regulation and Fair Trade Act. There is a list of the sort of conduct which would offend in terms of disclosure. The list comprises four items, three of which curiously are dependant on the prospective franchisee making a written request for information with which the franchisor does not comply. This suggests that if the prospective franchisee does not ask, the franchisor does not have to do anything.

The only conduct which does not require a request requires the franchisor to provide information relating to costs and fees, including franchise fees, security deposit money and other public fiscal obligations or not allowing the prospective franchisee sufficient time to review the data provided, the agreement and any annexures to it.

Information to be provided on request includes:

- the business history during the previous 5 years and financial and financial statements relating to the franchisor's business
- providing further information regarding the agreement because the prospective franchisee has difficulty in understanding certain provisions
- details of the status of the shop and its profit forecasts are to be assessed because the prospective franchisee has difficulty in understanding such matters

There are other provisions relating to equipment and product purchasing obligations; the failure of the franchisor to continue with the franchise ceasing to provide goods and/or services; imposing a new financial burden on the franchisee; the unilateral amendment of the agreement and the imposition of post termination restraints on competition without justification.

## Malaysia

The Malaysia Government has published a Franchise Bill which contains a wide ranging set of provisions covering:

- a registration requirement and the establishment of a Registrar;
- franchise agreement provisions;
- conduct of the parties and termination of franchise agreements;
- the establishment of a Franchise Advisory Board;
- offences and penalties; and
- enforcement.

The proposals are to apply to the sale of any franchise in or to be operated in Malaysia wherever the transaction is concluded.

There will be a Minister who will be responsible for matters relating to franchises. He will presumably have other responsibilities. The Minister will appoint a Registrar of Franchises and such number of Deputy Registrars and Assistant Registrars as may be necessary. It is clearly envisaged that the Registrar's office will be of significant size.

A franchisor will be required to register his franchise with the Registrar before he can make an offer to sell the franchise. A failure to do so will be an offence.

The information which will be required to be submitted to the Registrar is:

- an application in the prescribed form
- completed disclosure documents
- a sample of the franchise agreement
- operations and training manuals
- copy of the latest audited accounts and financial statements

- such other information as the Registrar may require; failure to do so within the time requested will result in the deemed withdrawal of the application necessitating a fresh application.

The submission of false or misleading information will constitute an offence.

The Registrar may approve with such conditions as he imposes or refuse (with reasons) an application and may require the payment of the prescribed fees.

Registration will normally be effective on the date specified by the Registrar. The Registrar will have the power to suspend, terminate, prohibit or deny the sale or registration of a franchisor but before doing so must give notice of his intention to do so with details and provide the franchisor with an opportunity to make written representations. The Franchisor is required to notify the Registrar of material changes to the disclosure documents.

Franchise brokers (i.e. those who sell franchises for franchisors) are required to register.

A franchisor is required to submit to a prospective franchise a copy of the franchise agreement and disclosure document at least ten days before the franchisee signs the agreement. Failure to do so will constitute an offence.

Each year the franchisor is required to submit a report to the Registrar in a prescribed form including an updated disclosure document. The Registrar may require the inclusion of additional information or a deletion from the disclosure document or issue an order suspending, terminating, prohibiting or denying the sale or registration of the franchise until any deficiencies specified have been corrected.

There is a right to appeal to the Minister in respect of any decision of the Registrar.

A franchise agreement must be in writing and contain at least the following information or provisions:

- the name and description of the product and business to be franchised;
- the territorial rights granted to the franchisee;
- the franchise fee, promotion fee, royalty or any relate type of payment which may be imposed on the franchisee;
- the obligations of the franchisor;

- the obligations of the franchisee;
- the franchisee's rights to use the mark or other intellectual property;
- the conditions under which the franchisee can assign his rights;
- a cooling off period of not less than 7 days when the franchisor may retain, out of any initial sum paid, the reasonable expenses incurred by the franchisor;
- a description of the mark and other intellectual property to be franchised;
- if there is a master franchise agreement details of the franchisor and the rights of the master franchisee;
- the type and particulars of assistance provided by the franchisor;
- the duration of the franchise (which must be not less than 5 years) and the terms of renewal;
- the effective termination or expiration of the franchise agreements.

The agreement may also contain provisions protective of confidential information and to restrain competitive activities. There is a prohibition against a franchisor unreasonably and materially discriminating between franchisees in charges offered or made for the franchise fees, royalties, goods, services, equipment, rentals or advertising services if such discrimination causes competitive harm to a franchisee who competes with a franchisee who benefits from such discrimination. There are some exceptions such as "discrimination" arising from and related to franchises granted at different times.

Where a franchisee is required to make a payment for promotion the franchisor will have to establish a Promotion Fund into which such payments are made. The Fund will have to be audited and the accounts filed with the Registrar.

Failure to comply is an offence.

There is a section of the Bill devoted to the "conduct of [the] Parties and termination of Franchise Agreement" which has a number of interesting approaches not all of which would be universally acceptable:

- The franchisor and franchisee have to act in an honest and lawful manner and pursue "the best franchise business practice of the time and place". The latter phrase is somewhat lacking in precision and will be open to varying interpretation.
- In their dealings with each other the parties have to avoid:
  - substantial and unreasonable over-valuation of fees and prices
  - conduct which is unnecessary and unreasonable in relation to the risks to be incurred by one party
  - conduct that is not reasonably necessary for the protection of the legitimate business interests of the franchisor, franchisee or franchise system.

One can imagine the problems which the provisions will raise in terms of the day to day conduct of the franchisees business and the contention which they will introduce into the relationship.

The franchisor has to give the franchisee an opportunity to cure breaches of the agreement which shall not be terminable except for good cause which is defined.

A franchisor will commit an offence if he refuses to renew a franchise agreement or to extend the term without compensating a franchisee either by repurchase (or by other means) at a price to be agreed after considering the diminution in value of the franchised business caused by expiration where:

- the franchisor refuses to waive any post term non-competition provisions or
- the franchisee has not been given at least six months written notice that the franchisor does not intend to renew the agreement.

On the other hand, the franchisee does not have to give any notice at all that he does not intend to renew the agreement.

One could, of course, argue that there is no diminution in the value of the business caused by expiration since if the agreement is for a fixed term it should be amortised to nil value over the length of that term. There is an inherent unfairness in asking a franchisor to buy a business or surrender the protection of a non-compete clause. The Franchisee may have acquired the business by purchase from an existing franchisee when the expression "repurchase" is scarcely appropriate. There is no mechanism to deal with

a failure to agree a price which must make a franchisor extremely vulnerable to prosecution. A franchisee's leverage on these circumstances is disproportionate to the perceived problem. Extension of a term will be a statutory right and the terms of the extended agreement must not be less favourable than the existing agreement.

A franchisor is required to provide assistance to a franchisee to operate his business such as the provision of supply of materials and services, training, marketing and business or technical assistance.

The fear may be that the expression "provide assistance to a franchisee to operate his business" could be interpreted to mean that the franchisor has to be providing a more "hands on" service than franchisors normally provide.

There is also a provision which requires a franchisor and franchisee to protect the consumer's interests at all times which seems to be a curious incision of consumer protection law into franchise law.

There is to be a Franchise Advisory Board comprising up to fifteen members who have wide knowledge and experience in franchising. The Board will advise the Minister and Registrar who will not be bound to act on that advice.

There are a wide range of penalties from two thousand ringgit to five years imprisonment. The Court may also order that the franchisor refunds any form of payment which he has obtained from any franchisee. This is the case despite the fact that the franchisee may have had full value and profit for and from the payment and that the contract must continue for at least five years and be automatically renewed. A payment to a franchisee of 7-8 years standing could well destroy a franchisor and the system.

It will not be possible to contract out of the law.

This proposed approach is fraught with difficulties. It upsets the balance between the parties and could well create for more problems than it will solve.

## **Mexico**

Franchise disclosure was introduced in June 1991 and implemented by a regulation coming into effect on 8 December 1994. The law also requires registration at the Mexican Institute of Industrial Property apparently for trademark purposes

There are ten headings under which information has to be given:

1. the franchisors name, domicile and nationality
2. a description of the franchise
3. how long the franchisor has run the business?
4. details of any relevant copyright
5. the nature and amount of payments to be made by the franchisee
6. the nature and extent of services and technical support to be provided by the franchisor
7. a description of the franchisee's territory
8. whether or not the franchisee has the right to sub-franchise and if so on what basis
9. the franchisee's obligations to maintain confidentiality
10. a general statement of the franchisee's rights and obligations

Franchise agreements are required to be registered with the Mexican Institute of Industrial property.

## **Romania**

Romania has passed an "Ordinance regarding the legal status of franchising".

As has so often proved to be the case with countries with little franchising (and others who should know better) experience the law clearly suffers from an imperfect understanding of the subject matter and an unfortunate level of inflexibility. The legislators appeared to have borrowed provisions from the EC block exemption regulation which were, of course, framed with competition and not relationship issues in mind.

A franchisor is defined as a trader who:

- owns a registered trade mark which will be valid throughout the term of the franchise agreement
- grants the right to operate or develop a business or product or technology
- trains the franchisee for the operation of the registered mark
- promotes the mark and through research and innovation ensures the development and validity of the product

This muddled thinking sets the tone for what follows.

“A franchise” is a marketing system based on continuous co-operation between financially independent persons whereby the franchisor grants the franchisee the right to develop a business, product, technology or a service.

“A franchisee” is a person selected by the franchisor who adheres to the principle of uniformity of a franchise network as defined by the franchisor.

“Know-how” which does not appear as a term in the other definitions is the entirety of elements serving for the manufacture and sale of a product.

“Franchise Network” means an assembly of contractual relationships between a franchisor and several franchisees to promote a technology product or service and for the development of the production and distribution of a product or service.

There is no registration requirement. The law is concerned with pre-contractual, contractual and post contractual relations.

The pre-contractual stage is concerned with the provision of information.

A franchisor has to provide the franchisee with information relating to:

- its transmittable experience
- the financial terms - not only initial fees, ongoing fees, advertising fees but how the purchase price of services and products will be determined
- the elements which enable the franchisee to make projections and a financial plan
- the area of exclusivity
- the duration of the agreement and the provisions relating to renewal termination and assignment.

A franchise agreement must reflect the interests of the members of the franchise network and protect the franchisor's industrial or intellectual property rights by maintaining the common identity and reputation of the network. The agreement must state, without ambiguity, the parties obligations and liabilities.

There are obligations imposed on both franchisor and franchisee:



The franchisor must:

- effectively run a pilot operation
- own intellectual and/or industrial property rights
- train the franchisee and provide commercial and technical assistance for the duration of the agreement

The franchisee must:

- develop the network and maintain its common identity and reputation
- provide the franchisor with information to enable it to analyse performance and financial statistics
- not disclose the franchisor's know-how to third parties during and after the franchise agreement.

The franchise agreement must include clauses detailing:

- its object
- the parties' rights and obligations
- financial requirements
- its duration
- conditions governing amendment, extension and termination.

A franchise agreement has to observe a set of principles:

- its term must be long enough for the franchisee to "recover the investments specific for any franchise"
- the franchisor must notify the franchisee long enough (without saying what it has to be enough for!) if it intends not to renew

- conditions for termination without which must be precisely defined
- the conditions for the transfer of rights arising from the agreement must be clearly defined
- a pre-emption right must be provided if the interests of marketing and expanding the network requires
- there must be a non-competition clause to protect the know-how
- the franchisee's financial obligations must be clearly defined

The agreement enables the franchisor to control its trademarks.

The franchisee has to publicise that he is financially independent from the franchisor.

A franchisee has to be given reasonable time to remedy any breach of the agreements.

Post contractual relations have to be based on rules of fair competition. The franchisor may impose strict obligations to protect the confidential nature of the business and the non-use of the know-how by a competing network.

There are some provisions dealing with exclusivity which seem to assume that there will be an exclusivity fee and that it will be pro rata to the admission fee and in addition to it (one might be excused for having difficulty in understanding this provision). An exclusivity agreement must contain a termination clause accepted by both parties which shall deal with reimbursement of the exclusivity fee.

There is a curious provision borrowed partially from Article 85(3) of the EC Treaty which states that "By its organisation and development a franchise network must contribute to the improvement of products and/or distribution of products and/or services".

The law also deals with advertising for franchisees which must be free of ambiguities and inaccurate information. Any advertising documents prescribing financial projections of a franchisee must be objective and accessible. Presumably, this is intended to refer to profit projections.

The franchisor must ensure that the franchise network maintain its identity and reputation.

## Russia

Russia does not have a disclosure law - it does have a registration requirement but its law does not explain how one should register the agreement or what is the purpose of registration.

The fact that Russia has a law relating to franchising is an oddity since there is not a lot of franchising in Russia. This is a case where the law has come before the commercial practice and it contains provisions which many franchisors will regard as discouraging. The law was adopted as Chapter 54 of the Russian Civil Code on 22 December 1995 by the State Duma and approved by the Federation Council on 25 January 1996. It is at the time of writing somewhat early to judge the effect of the law and how it will be enforced.

The law is woven with ideas and concepts and demonstrate the difficulties the legislators had in coming to an understanding of franchising and master franchising.

A few examples of provisions in the code include:

- the franchisee has a right to renew the contract on expiry of the term on the same terms as those contained in the original contract - if the franchisor refuses to renew it cannot enter into a similar contract covering the same territory for a period of three years unless it pays the franchisee compensation
- the franchisee (and the franchisor for that matter) has the right at any time to terminate on six months notice if the contract has no fixed term
- in the event of the death of the franchisor (presumably this only applies to private individuals) his heir automatically succeeds provided he has registered as an entrepreneur within six months. If he does not take up the role within the six months then a manager appointed by a notary public takes over during that period. If the heir does not become registered as an entrepreneur the contract is terminated
- there are provisions relating to the liability of the franchisor for acts or defaults of the sub-franchisor or sub-franchisee

## Spain

The basic law was enacted on 5 January 1996 and was implemented by a regulation adopted on 17 November 1998 which came into force on the 27 November 1998.

The basic law requires that 20 days before a contract is signed or money paid by the franchisee to the Franchisor that the Franchisor must provide the franchisee in writing with all information regarding the franchise network with the objection of enabling the franchisee to be in a position to decide freely and knowingly whether or not to enter into the contract. The basic law lists the following heads of information required

- essential identification regarding the franchise
- a description of the market
- the exploitation structure and extension of the networks
- the essential provisions in the franchise agreement

As one might expect the regulation provides the essential level of detail. The regulation provides for both pre-contract disclosure and registration. The registration requirement seems to be concerned with providing the central and regional governments with details of all franchisors operating within their territories. This should provide some statistical evidence of the extent of franchising and its growth in Spain as it is expressed to be for the sole purpose of information and publicity. The regulation defines what it means by "trading under the franchise regime" and achieves it by borrowing heavily but not entirely from the EC Block Exemption regulation whose provisions it appears to be adopting as a benchmark. The regulation also defines a Master Franchise agreement which it describes as a "Principal franchise agreement". One is inclined to wonder whether the effect of adopting the definition in this form will lead to franchisors drafting agreements which do not meet the requirements of the definition to ensure that the regulation does not apply to them.

Disclosure which must be accurate and not deceptive must be made at least 20 days prior to signature of the franchise agreement or a provisional agreement (e.g. deposit agreement) or the payment of any money. (This is similar to the French requirement).

The information to be disclosed includes:-

### Details of the Franchisor

- corporate name

- registered address
- details of inclusion in the register of franchisors (see below)
- paid up share capital
- if a foreign Franchisor in addition to the share details of inclusion in the register of franchisors in which they are obliged to register under the laws of their country (or state) of origin
- In the case of a principal franchisee (sub-Franchisor) details of the above in relation to the principal Franchisor (Franchisor).

### Trade Marks

Evidence of ownership or rights to use (and for what period) and any possible legal proceedings.

### Franchise Activity

A general description of the sector of activity and its most noteworthy features.

### Experience

Details of the Franchisor's experience including:-

- date of incorporation
- the main stages and history of the development of the franchise network

Content and characteristics of the franchise and its exploitation including:-

- a general explanation of the system of business
- the characteristics of know-how and permanent commercial or technical assistance to be provided to franchisees
- an estimate of setting up costs
- if profit and sales projections are given (this is not obligatory) they must be based on experience or studies and be sufficiently justified.

### Structure and system of the network in Spain:

including:

- the form of organisation of the network

- the number of outlets in Spain by
  - company owned and
  - franchised
- the location of outlet
- the number of franchisees who have withdrawn in the preceding 2 years stating why.

### The Franchise Contract

The essential elements including:-

- the rights and obligations of the parties
- its duration
- conditions for termination
- renewal provisions (if any)
- economic considerations
- exclusivity agreements
- restrictions on the sale of the franchise by the franchisee

### Confidentiality

The Franchisor shall be entitled to require a franchisee to enter into an undertaking to keep pre-contractual information confidential.

The following provisions relate to the Register.

### Its creation

- The register is created for the sole purposes of information and publicity and has a public and administrative nature and character
- The register will be administered by the Directorate General for Domestic Trade of the Ministry of Economy and Finance
- Registration must be made of the persons who intend to perform the franchise in Spain prior to the sale of the franchise when the franchise to be operated is in more than one Autonomous Region.

### Franchisers

- The inclusion of Franchisers on the proposal of its Autonomous Governments where they have their registered office - an identity code will be allocated by the state registrars.
- Regular updating of the list of franchisees and the preparation of statistics
- Cancellation of franchise if required by the Autonomous Government.
- The issue of certificates of registration.
- Provision of access to the Register for Autonomous Governments
- The provision of information about franchisors of a public nature to interested parties.
- The inclusion of franchisors who have no registered office in Spain.

#### Documentation to be filed

Application for inclusion in the Register shall be filed with the competent authority in the Autonomous Government where the Franchisor has its head quarters.

At least the following details have to be provided:-

- Particulars of the Franchisor
  - name/status
  - registered office
  - details of inclusion in the Mercantile Register
  - taxpayers number or business identification number
- Details (including ownership or entitlement to use) of industrial or intellectual property rights to which the agreement refers, their duration and of any legal disputes.
- A description of the franchised business and its activity:
  - number of franchisees and their outlets
  - number of company owned outlets;
  - including where the outlets are located and
  - how many franchisees left the network in the previous 2 years.
- Where there is a sub-franchisor it must provide particulars of its Franchisor comprising name, corporate status; registered address, legal status as well as the duration of its agreement with its Franchisor.

#### Obligations

Where there is a change in the information provided relating to the particulars of the Franchisor, the industrial or intellectual property or the franchised business and its activity it must be notified within 3

months. If the Franchisor ceases franchise activity this must be notified forthwith. In any event the information must be updated in January of each year.

The Register may be computerised and the Registers operated whether centrally or by Regional Governments have to be co-ordinated.

### Transitional provisions

Franchisors whether based in Spain or not who sell franchises in Spain have one year to register (i.e. before 27th November 1999).

## USA

The United States has both federal and state laws which directly affect franchising. What follows is a brief introduction to what a is complex web of legal requirements.

At the federal level there is a precontract disclosure requirement created under statutory authority by the Federal Trade Commission. The rule applies throughout the states except where state laws are more restrictive. The North American Securities Administrators Association has devised a Uniform Franchise Offering Circular (UFOC) to enable a standard format to be used which complies with both federal and state disclosure laws. There are a variety of state legal requirements the most stringent of which are those which require registration of the franchise offering as well as the delivery of a pre-contract disclosure document. Some require disclosure but not registration; some have neither regulation nor disclosure.

The following is a brief list of the information which has to be included in the UFOC.

- the identity of the franchisor, its trade name and trade marks
- the business experience of the franchisor's, directors and officers
- the franchisor's business experience
- the franchisor's litigation history (to include that of its Directors and Executives) Litigation covers criminal civil and administrative procedures
- the bankruptcy history of Directors and Executors
- a description of the franchise
- initial funds required to be paid by a franchisee
- details of persons affiliated with the franchisor with whom the franchisee is required or recommended to do business
- Obligations to purchase



- revenues received by the franchisor in consideration of purchases by a franchisee
- Financing arrangements
- Restrictions imposed on the franchisee in regard to sales
- personal participation required by the franchisee in the operations of the franchise
- termination cancellation and renewal of the franchise
- statistical information concerning the number of franchisees and company owned outlets
- site selection
- training programme
- ~~public figure involvement in the franchise~~
- financial information concerning the franchisor

There are no private rights to enforce compliance with the FTC rule - the FTC are the enforcement agency and can apply for (among other things) injunctions to prevent continued non compliance

The state laws provide franchisees with remedies which include the right to rescind and claim damages

## CONCLUSION

### INTRODUCTION

In my paper "Franchising - What now?" I reached the conclusion that educational support for franchising in both domestic and global market places was an essential requirement. I also believe from my experience that such educational resources as are available are woefully inadequate and that many operating in the market place do not appreciate their deficiencies in knowledge. I suppose that having gone into franchising in its relative infancy and having had a broad business and legal exposure at that stage, I always found myself in a position where I have been passing information on to others. This has made me more conscious of the knowledge gaps and the great need there is to ensure that they are filled. The books which I have written, as well as the countless articles which have been published throughout the world have been part of my attempts to make a contribution to providing basic educational information to those who had aspirations to enter franchising as well as those who are already experienced. In this paper, I have sought to identify the many involved in franchising, the provision of services to the franchise sector, as well as those who may influence franchise development and practices, eg. legislators. I have also produced an illustration showing how people get involved in complex advanced arrangements without having acquired the basic underlying knowledge which is so essential for their success. I believe that this demonstrates that the educational requirement is not limited to those involved in franchising but to the whole range of people identified below.

The publication "How to Franchise Internationally" is part of an ongoing series of books which I have written on various aspects of franchising since 1970.

The emergence of the various books over the period have reflected what I perceived to be the needs of the moment given the developments current from time to time.

My perception was confirmed by the views of the various publishers of the works whose commercial decisions would undoubtedly have been influenced by their view of the market place.

The first book was "The Guide to Franchising" and published in 1970 with the sixth edition to be published in the summer of 1999. That book was commissioned in 1969 by a publisher who wanted to publish a book on franchising. In 1970 franchising was still in its infancy and there was no information published in the UK and not a lot available in the USA. The book was based upon my experience in being involved in the business of a franchise company and in giving legal and business advice to clients.

This basis has flowed through all the books which I have written. The sources of my information and knowledge throughout have been:

- my experience of the business of franchising
- my experience in providing legal advice to clients arising from their business problems
- the need to assist clients in structuring their arrangements to obtain the maximum benefits from the techniques which franchising provides
- preparing and writing articles for franchise and legal journals
- preparing and delivering lectures to audiences worldwide
- listening to franchise practitioners describe their experiences in practical franchise management
- reading articles and publications by others
- participating in panel discussions and debates before audiences worldwide
- lobbying legislatures and governments on behalf of the franchise associations and companies
- advising governments and franchise associations
- listening

I must say that I have found the greatest learning experiences have been preparing for lecturing and writing articles. There is a considerable learning experience to be gained from the thought process which one is obliged to undergo in order properly to prepare articles and to lecture. There is also much to be learned from listening to one's clients and the questions posed by delegates at the seminars and lectures which I have presented. Very often, a chance comment can stimulate a fascinating line of thought.

Once it was generally appreciated that I had a knowledge of the subject I was in demand as a speaker at seminars in the UK and abroad. In the early days there is no doubt that there was a need for these seminars

to educate those who wanted to create new franchise systems as well as those already running systems who wanted to increase their knowledge.

At that time there was an emphasis in the only franchise magazine which was then being published (Franchise World) on providing information about the basics of franchising. I was asked to write the appropriate articles. As I have explained in one of my earlier papers the series of articles which I wrote for that magazine formed the basis for "How to Franchise Your Business" and "How to Evaluate a Franchise" designed respectively to assist prospective franchisors and franchisees.

The educational value of these books has been recognised by franchise associations around the world. They have been published in a number of languages and are widely used to assist franchisors and franchisees in developed as well as developing countries. Indeed, the two countries in which most sales take place are England and Australia.

Even in the early days of franchise development there were franchise systems which had global aspirations. The early entrants to that global market were those businesses which served the international traveller such as:

- hotels; and
- car rentals

It was evident that global development would grow but it has only become significant in the last 15 years.

It was not until 1989 that the first edition of "How to Franchise Internationally" was published. This was based upon a series of articles which I wrote for Franchise World during 1987-88 when the need for information which the articles provided became very topical. The first edition was very successful and was accepted by the same franchise associations as had welcomed the two earlier "How to" books.

I was asked by the publisher to prepare a second edition which corresponded in time with this course. This gave me the opportunity to consider a substantial review of the original work. I concluded that although the article series basis had worked well it was the time totally to restructure the book. There had been another book on the subject published by a Canadian lawyer who had asked me to write a foreword for it but there is little else on this subject.

I felt that the subject merited a much expanded version and the restructuring of the chapters and their contents. The source of my material as with all my publications is my experience and the conclusions I have drawn based on that experience without losing sight of the other factors I have listed above.

I find myself in an invidious position. As I was among the first on the scene and an early author on the business as well as the legal aspects I have always been regarded as one who could provide creative and innovative solutions. As may be appreciated, from my earlier papers many of what are now regarded as fundamental principles of franchising, eg. the necessity of having pilot operations, first saw the light of day in my writings. In the legal sense the contractual precedents I created were originals and have been widely and blatantly plagiarised setting the tone for the legal framework and practice in this field.

In each of my successive publications I have been able to expand on the treatment of the subject matter and to extend the range of topics with which I have dealt.

In the second edition of "How to Franchise Internationally" Chapters 2, 4, 6 and 7 are substantially new and the other chapters have been re-organised and laced with new material. The total work is almost twice the size of the first edition.

Since franchising is fundamentally a method of marketing goods and services it is not confined to any particular business categories. Indeed, it transcends virtually all business categories and types.

One of my experiences which has always come as a great surprise to me is how many business people who should know better consider franchising to be a novel departure from what they already know. Franchising has borrowed its technique and elements from other business relationships, eg. Patent licences, know-how agreements, trade mark licences, distribution and agency arrangements and brought them together in a manner which has proved to be most effective. Of course, other elements have been added principally in the areas of "people handling" and the welding together of two parties who have often conflicting objectives.

One should not underestimate the object lessons derived from franchising for other businesses. Because a franchisor has a responsibility to others (ie. The franchisees) it requires a far more painstaking and thorough approach than many engage upon when only considering their own businesses. After all a franchisee does not need a franchisor to help him on the road to bankruptcy - he can manage that by himself.

One would consider given the relative maturity of franchising that the information available and in the public domain would render training and education in franchising largely unnecessary. However, there

is no doubt in my mind that there are vast numbers of those involved or wanting to be involved in franchising who do not have a sufficient understanding of the subject to enable them to avoid errors and take the maximum advantage of what it offers.

This level of ignorance is found in purely domestic operations and when venturing abroad the scope for mistakes is magnified.

Professional client privilege prevents me from naming some of the major international giants of franchising who have made and are still making significant errors in their international activities. I was recently consulted by a "household" franchising name - in the market for at least 40 years and global, about their current international franchising techniques and contract. As I discussed my review with them I lost count of the number of times that they said to each other "if we only had had that provision in our agreement we would not have had problems in [country X] Y,Z, etc. (see "Franchising - What Now?"). Some may consider that astonishing but for me it has become so common that I almost expect it.

This brings me to the thread running through my conclusions which is that education is vital if we are to ensure that franchising develops to its full potential and that all involved in it make the proper contributions.

There are now so many involved:

- franchisors
- would be franchisors
- franchisees
- would be franchise developers
- would be master franchisees
- business people in the developed world
- business people in the developing world
- legislators
- governments
- civil servants
- suppliers
- customers

- academe
- business consultants
- lawyers
- accountants
- real estate companies
- surveyors
- architects
- inter-governmental organisations eg. OECD, Unidroit

The list is almost endless.

One could use a building as a basis for an analogy.

Let us view a building like that illustrated below:

<u>Category</u>		<u>Knowledge</u>
International Master Franchisee	6th Floor	Often basic
International Area Developer	5th Floor	Often basic
New International Franchisor	4th Floor	Should be advanced but often is barely basic
Domestic Area Developer	3rd Floor	Basic
Mature Domestic Franchisor	2nd Floor	Advanced
Domestic Start-Up Franchisor	1st Floor	Basic
General Public	Basement	Scanty

There could be other subdivisions and there are also differences between developed and developing world although these are not necessarily as large as one might expect. There are a number of factors to be considered:

- not all the staff of a franchisor and franchisee have the same level of knowledge. The top man may have advanced knowledge while the rest of the team have less knowledge
- the educational needs at each level often are not properly understood
- there is little recognition of the fact that all the upper floors are dependent upon the right levels of knowledge at the lowest level - building a franchise system domestically and then

internationally is progressive - like constructing a building - hence my analogy. If the basic learning is not there the advanced knowledge required to progress across national boundaries will not be soundly based

- an example of flawed thinking is the Unidroit project. Unidroit is an inter-governmental body which seeks to produce international codes which can be adopted by its member and other states.

It investigated franchising and concluded it was inappropriate to have such a code. However, it was under pressure from its developing world members to provide them and their nationals with guidance when confronted with negotiating master franchise agreements. The problem with that approach is that the prospective master franchisee does not have basic guidance in what franchising is and how it actually works in practice. The guidance produced for him is at a higher level than his knowledge base - he is being thrown in at the deep end. I am a member of the Unidroit working party but I can at least say that I was opposed to Unidroit getting involved at all. Once they decided to do so I felt obliged to make the best contribution I could.

- The Unidroit illustration really underlines the educational problem. The only sources of education are:-

- publications many of which are not appropriate for the purpose
- seminars of which many are organised by franchise associations as well as commercial interests. Indeed, my firm under my direction hold 6 to 8 seminars each year. We have managed to persuade many franchise companies to recognise the contribution which they can make to educating their staff.
- educational establishments. There are some offering courses in the USA, Australia, South Africa and hopefully MUBS in England. The courses are of varying quality - one factor is certain and that is that there are not enough good quality courses in enough countries around the world. How can one hope to educate countries like China and India without a proper educational infrastructure which is based upon sound learning and knowledge of this subject. I could produce a longer list which would include such countries as Russia and Indonesia with their respective vast populations. My own world travels and lecturing activities have demonstrated to me how much needs to be learned even in countries with supposedly mature franchise communities.



## **CONCLUSION**

**There is a vast gap in the educational resources available and a great need for that gap to be filled for the reasons set out in my paper “Franchising - What now?”. Namely, (1) to ensure that the supporting infrastructure to service the franchise community is in position and well equipped to provide what is needed, (2) to equip better those operating in domestic and global markets, and (3) to ensure that legislators and their advisers have a proper knowledge of the subject matter about which they are legislating.**

**Meeting the educational need provides a realistic prospect of ensuring that standards are raised and that franchising will move forward with greater prospects of assisting those involved to achieve success without suffering the setbacks from which so many presently suffer.**



# How to FRANCHISE INTERNATIONALLY

MARTIN MENDELSON

Special edition for



EVERSHEDS



# *How to Franchise Internationally*

Dedicated to the memory of  
Rebecca, Arthur and Jeffrey Mendelsohn  
and  
Rebecca and Abraham Sobell

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*By Robert M. Rosenberg*

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## **Foreword**

I found this book by Martin Mendelsohn an absolutely essential guide to the do's and don'ts of international franchising. I believe Martin is uniquely qualified for this task.

In addition to his role as a solicitor, Martin assumed responsibility in the 1960's as managing director for Dunkin' Donuts in its early entry into the UK marketplace.

Martin was present at the beginning of franchising in Europe and for the past 35 years has been a shaper, educator, and participant in its growth. His advice is founded on years of experience and success that few, if any, can match.

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# Introduction

IN the first edition of this book published in 1989 I wrote

*"Franchising has grown considerably throughout the world in the last three decades, but the rate of growth which has occurred during the last three to four years, and that which is projected indicates that its development is continuing to accelerate"*

At that time the countries of Central and Eastern Europe were moving from a managed to a free market economy and many developing countries were beginning to recognise the valuable contribution which franchising as a technique and the many operating systems could make to business and job creation as well as raising standards in indigenous businesses faced with competition from quality controlled suppliers to the franchising systems. These developments and the emergence of China and India with their vast populations has greatly increased the scope for franchisors to expand their operations globally and it is clear that they are doing so in ever increasing numbers.

Franchise systems in their domestic environment are organised in such a way that the ability to grow is inherent. Recruitment of franchisees, training them and helping them to become established in business is fundamental to the way in which systems grow. It may seem but a short step to move with the same *modus operandi* into another territory. To the unknowing, unseeing or unlistening the path to international development may seem easy or straightforward but it is not.

There are many lessons which those who have tried to expand internationally have learned from their experiences but all too often those who are new to this field make the same mistakes and do not benefit from the guidance which is available.

The purpose of this "How to" book is to introduce the reader

## *Introduction*

to the subject in its many facets. Much of the time it is not possible to say what should be the right outcome in relation to the issues to be confronted because in the final analysis all international franchise contracts are negotiated. What one party will agree in one case, another will not in a similar case. It all comes down to what each party expects from the relationship and their relative bargaining power. A difficulty frequently encountered is the shortage (or absence) in many places of advisers with sufficient knowledge or experience to smooth the progress of transactions.

Suffice to say that those franchisors who treat a target territory with most respect and who recognise the differences which exist and seek to understand them, are those who at the end of the day do best.

Thorough preparation is essential in taking one's franchise international, not only in dealing with business and legal issues but also those which arise from the language culture, lifestyle, tastes, behaviour patterns and even climate.

In this work the international master franchise agreement will be called "the master franchise agreement"; the parties to the agreement will be called "the franchisor" and "the sub franchisor" respectively; and the operator of the franchised unit will be called "the sub-franchisee". This terminology is recommended by the International Franchising Committee of the Business Law Section of the International Bar Association which prepared a lexicon of terms in an effort to promote the uniformity of the use of terminology in franchise transactions. The lexicon may be obtained from:

The International Bar Association  
271 Regent Street, London W1R 7PA, England.  
Telephone (+44) 0171 629 1206.

The text of the lexicon was also published in the *Journal of International Franchising and Distribution Law* (1987 JIFDL 58).

While I have based this second edition on the first edition, I have made a number of changes including the order in which I

## *Introduction*

have dealt with the subject matters. The text has also been substantially re-written and extended.

Chapter 1 in this edition was Chapter 2 in the first. Chapter 3 was Chapter 3 but the title has changed; Chapter 5 was Chapters 4 and 5. There are new chapters. Chapter 2 was formerly part of the introduction but I have moved and expanded it. Chapter 6 is new; I thought it would be better to consider the financial issues under one heading. Chapter 4 is new; increasingly franchisors are using the technique of Development Agreement in international expansion and I thought that one could not ignore those trends. In view of the growth in franchise regulation in various countries I have introduced Chapter 7 in which I have summarised what is the position at the present time. I am sure it will change.

I would like to thank my partner Chris Wormald for reviewing the text and for his valuable comments. My thanks also to my secretary Julie Woods and the ladies in Eversheds, London, word processing department. My thanks also to Bob Riding for his continued support.

Martin Mendelsohn

## CHAPTER ONE

# **Taking the decision to franchise internationally**

INTERNATIONAL franchising is not easy, but if done properly for the right reasons and with the availability of the right resources it can, in time, produce positive results.

However, many franchisors have made fatal mistakes in overseas operations and these mistakes have not been limited to small companies. Some well-known and successful names in franchising have found to their cost just how difficult it can be to transplant and operate their formula in a new country. The larger of these companies have had the resources and time to enable them ultimately to sort out their problems. The smaller companies do not have the resources which would provide them with the luxury of time to remedy major errors. There are a number of business and practical issues which have to be considered in coming to the decision to begin franchising internationally.

Firstly, there must be a sound business reason for overseas development. A mere ego trip in order to try and satisfy a craving to be in a position to boast that one is an international franchisor is simply not good enough. There have to be better reasons. For example, is the home market saturated or approaching saturation? Is the franchise so well established in its own country that the time is now propitious to broaden its horizons? Are there real market opportunities abroad which present themselves which are too good to miss?

In the same way as some domestic operations start up due to the pressure of interest from those who would like to take up a franchise, many successful franchisors find that they receive approaches from abroad from those who would like to introduce the franchise into their own countries. Such approaches are fine and very flattering, but whether or not one is in a posi-

tion to accede to them will involve a proper and thorough evaluation of all the many basic issues including many of those referred to below. The fact that such an approach has been made does not mean either that the person making the approach is suitable or that the franchisor can by-pass taking the normal informed decisions or from taking all the other safeguards to which reference is made in this work. However there have certainly been enough cases where deals have successfully been concluded to justify taking such approaches seriously.

There are, of course, franchises which particularly lend themselves to being operated on an international scale, such as product distribution franchises at retail or wholesale levels, and hotel and car rental firms catering for international business travellers and tourists.

Is the reason or desire to become international in scope merely there in order to be able to claim one is ahead of competitors in the race for growth? Again, as with the ego trip, this can be a dangerous approach, particularly if the other relevant factors are ignored in a wave of blind optimism and an arrogant belief that it would be an easy task to achieve.

It is a principle that a company should not regard franchising as a panacea for the ills of an ailing business which will be solved by an immediate inflow of money. That does not work in the domestic market and as will become apparent it cannot work in the International Market either. One cannot of course rule out the "conman" prepared to sell a "territory" for a large up front fee without the prospect of delivering what he has promised.

What can happen, of course, is that if the international expansion is not done at the right time or well enough, it can significantly drain the resources available to the domestic operation and hamper its development. The franchisor's reputation will be damaged by failure in one or more overseas countries and may mean that those countries' business people will not be receptive to subsequent attempts to enter the market at least for a considerable time.

There are some prerequisites to franchising successfully overseas.

- The franchisor must have a sound and successful home base which is sufficiently profitable. The financial position of the franchisor must be secure and it must have resources which are surplus to, or which can exclusively be diverted from, its domestic requirements. The franchisor must appreciate that from the moment the decision is made to expand internationally there will be expenditure. Exploring which may be the best country and sending someone there to "fact find" will cost money. No international deal can be signed so rapidly that the money is coming in from the time or even shortly after it starts to go out! In reality a realistic budget has to be prepared to cover the probability that international expansion is long term not short term and that costs will be incurred for some realistic period of time before income may result.
- The franchisor must also have manpower resources available which can be devoted solely to the international operations, and, above all, it must be patient. Patience is a necessary attribute for franchisors operating in their own domestic markets. Entering into contracts with franchisees in haste often leads to repentance at leisure and at great cost. International operations are no different in terms of patience - in addition one would suggest that the franchisor must always feel secure enough to be able to say "No" unless it is sure that the deal and the other party are absolutely right - the cost of making the wrong choice in the international transaction will be greater than is the case with a domestic operation. If things go really wrong the costs of extricating oneself can escalate rapidly.
- It is essential to find the right "partner" in the target territory. This is not easy. It is difficult to make contact with those who may be most appropriate as franchisees whichever structural approach is chosen (see below and in Chapter 3).

On the whole, the development of international markets will always take longer and make greater demands on both the



financial and manpower resources of the franchisor than is first anticipated. While it is difficult to generalise this is very much likely to be a case where it is - "take the figure one first thinks of and multiply by a factor of 3" - and apply it to direct cost, manpower and the time one reckons it will take to be up and running in the first case.

It is quite likely that as one gains more experience it may be possible to speed up the process but one must never do so at the expense of not taking all the same safeguards which should be taken out at the outset in all subsequent cases. A belief in the maxim "been there; done that; got the T shirt" can create a climate of comfort, confidence and indeed arrogance which can become very expensive. It is suggested that even the most experienced franchisors have "war stories" which very much support a case by case approach applying each time the same basics. Never relax. Never become over confident. Always be patient, and never get into the position where one cannot say "No".

The build-up of the international operation will take time because just as one is urged to operate pilot outlets in one's own domestic market, it is equally as prudent to do so in the target country; who bears the expense of such pilot operations will be part of the negotiations between the parties (see Chapters 4 and 5). This concept of pilot operating is important in many cases not only to ascertain whether the business is viable in the new country, but also to fine tune the operational side to conform to local customs, culture, habits, business practices and laws, and not least to cope with the problems which may arise through the need to use a different language, necessitating the translation and revision of operational manuals and other written material. There are other factors which can have an impact and to which consideration must be given.

- Is the target country one which has a history of political stability? The less stable the political climate, the more difficulties are likely to arise, particularly where there may be controls over the movement of funds, or over the involvement in the country of foreign companies. There can also be the risk of

confiscation of a business in unstable countries. The instability in some countries which have been the subject of United Nations sanctions have caused many companies to withdraw, in some cases leaving trade marks and also intellectual property rights unprotected.

- What degree of government control over, or interference with, the normal arm's length negotiating process between the parties can be expected? Will these requirements impose the reopening of negotiations and a dilution of the franchisor's bargaining power with adverse financial consequences?

- Are there monetary exchange controls which might limit the amounts of franchise fees or prevent the repatriation of profits, or the remittance of funds? If so can consents be obtained and will they be honoured over the long-term? How long will it take for funds to be remitted? Can one rely on a steady flow of cash or will it be intermittent? In some countries, funds can even be delayed for which permission to remit does exist. These delays can some times be for long periods because the country's central bank does not have adequate foreign currency resources to enable the payments to be made. There are sophisticated methods of barter and counter-trade which can some times be used to overcome this problem, but there has to be a reasonable scale of business to justify these types of involved arrangements.

- Are communications and distribution good? As with domestic operations, the speed effectiveness and efficiency of communications and distribution systems are an important factor. In the developing world problems are frequently found with such systems.

- Many franchise operations rely on what is described as the discretionary spending power of their customers. The product or service supplied is not essential, and customers do not necessarily need to buy it. In such a case the question of how much money is available in consumers' pockets after they have met their essential living requirements is an important issue.

The franchisor will also have to be able to provide the neces-

sary training programmes. If it is geared up to provide a high level of training in its own domestic marketplace, it may find that it is well placed to extend the programme to cope with the overseas operations. Many consider it invaluable, certainly in the early days, to provide training at the domestic training facility so that an in-depth understanding of the operation can be achieved. It is essential however to be sensitive to the requirements and conditions in the target territory. The cost of sending personnel to the franchisor's territory may be inhibiting particularly for sub-franchisees and there may well be problems with language skills since one can scarcely impose on sub-franchisors the requirement that they can only recruit as sub-franchisees those who are sufficiently fluent in the franchisor's language to attend and understand the franchisor's training course. This would also mean that sub-franchisees would only be able to sell their businesses to those who are also similarly fluent. That would create a barrier to sales which would be untenable.

Lastly, and by no means the least important factor, is that the right person or company with whom it would be fitting to be associated has to be found for the target territory. After all it is hardly surprising that it can be difficult to identify the right person in a foreign country, for as franchisors are well aware, it is often difficult even in one's own country to select the right franchisees. What is surprising is how many companies with significant experience in franchising have failed to recognise that this is a vital matter or to approach it with the serious attention to detail which it requires.

In the same way that many franchisors find it difficult to recruit the right people as franchisees and to display the patience which is necessary, so one finds that franchisors venturing overseas are confronted with a similar problem, but here it is compounded by the fact that they are operating in an unfamiliar environment and the difficulty which exists in making contacts. There have been many who have made bad choices which could have been avoided had they been patient and exercised the same degree of care in selection as they would have taken in choosing franchisees in their own country.

## *Taking the decision to franchise internationally*

If the prospect of expanding internationally continues to appeal after considering and evaluating the factors reviewed in this chapter, then one should move to a consideration of the business and legal issues with which one will be confronted.

CHAPTER TWO

## **Business and Legal Audits**

HAVING taken the decision to go international, whatever the choice of country, the prospective international franchisor is well advised to learn something about each of its target countries if it wishes to be well equipped in its negotiations with prospective franchisees of whatever category with which it intends to do business.

There are two aspects: - the business and the legal, but in considering them one must not lose sight of the other background factors which affect both of those aspects and which include government attitudes and policies which may affect both the business and the legal climate.

Some governments have an attitude towards franchising; some are indifferent; many do not understand it. Apart from any particular attitude there may well be governmental initiatives from which incoming as well as indigent business can benefit. These include special incentive schemes and grants which may be available for certain types of business or industry or in certain "depressed" areas or regions.

We shall first consider the business aspects and what one would describe as the business audit. From the business point of view it should be appreciated that what the franchisor is doing, whatever structure it may choose (see Chapter 3), is establishing a business in a foreign country. The fact that it involves a franchisor franchising and a franchisee in whatever capacity does not detract from that fundamental fact. As we shall see when we examine development agreements and master franchise agreements there will be debate and agreement about who runs the risks inherent in establishing the system in the target country but the issue arising out of the establishment of a business in the territory owes nothing to the fact that it is

franchising which is involved.

A franchisor cannot, on the whole, expect that its franchisee "partner" will readily materialise and accept everything at face value. The franchisor should not assume that anyone who expresses an interest in the franchise will be suitable. These statements may seem obvious but there are many franchisors (some significant and allegedly sophisticated in the ways of business) who have failed to give them the importance and credibility which they deserve. Since depending on the route chosen the franchisor may be dealing with any one of three types of franchisee it is difficult to generalise. If the franchisor decides directly to franchise to individual unit franchisees it will be looking more probably for people in the target country who are the counterparts of its franchisees in its domestic market. If its decision is to recruit area developers who will open a multiple number of franchised units it will be considering a different calibre of person or business entirely. If it decides to enter into a master franchise agreement with one person or company for each target country the calibre of person or business entity and resources available will be different again.

Finding and selecting the right local firm or business will be crucial to the franchisor's prospects of success. Unfortunately there is no easy way to match the franchisor seeking the local "partners" and the local would-be "partner". In some cases this occurs because the would-be franchisee on his travels around the world sees a business concept which appeals to him and he makes a direct approach to the owner of the concept with a view to taking up a franchise in his country. Other methods of making contact include:-

- Exhibiting at one of the increasing number of franchise Expos which are held in various parts of the world. There have been significant increases in the number of would-be franchisees from around the world who attend the Expos in the hope that they will be able to find suitable opportunities
- Advertising in the franchise media in the target country; in some countries the newspapers have "business to business" and

"business opportunities" advertisements in which franchisors advertise their franchise. If the qualifications required by the franchisor require some form of previous experience or business exposure in the particular trade or industry with which the franchise is involved advertising in the relevant trade journals may stand a better chance of success.

- Many countries have commercial offices attached to their embassies whose function it is to help business people become established in foreign countries. The use of such offices may enable appointments to be made with local business people if a visit to a targeted country is envisaged.
- Many professional providers of services including, banks, lawyers and accountants have contacts in other countries and may be able to help.
- Having editorial copy (not paid for advertorials) appear in the relevant media in the targeted countries may enable the franchisor to reach those who may be interested.

Having the right person or business in place is extremely important and achieving this is fundamental to the achievement of the business audit.

There will be a number of factors to include, whatever the chosen method, and thus the relevance and weight to be attached to them.

In all cases the franchisee will need to have the appropriate level of financial and manpower resources available to him. If it is a unit franchise the level of these resources will be less than will be the case where a development agreement is envisaged, and if there is to be a master franchise the level and nature of the resources will be greater.

The franchisor will also have to assess the ability of the prospective franchisee at whatever level is appropriate to cope with the needs of the business. A unit franchisee will not need the same skill levels or resources as a developer or a sub-franchisor.

Uniquely of the three, the sub-franchisor will need to be

assessed for his ability to;

- Learn how to run the franchised business at unit level
- Make an essential contribution to the process of adapting the franchise system to the market requirements in the target territory
- Demonstrate an ability to act as the "franchisor" in the target territory
- Satisfy the franchisor that he will prove to be a sound guardian of the franchisor's System, Trademarks, Trade Secrets, goodwill and reputation by accepting a level of control by the franchisor and by imposing in practice (not just in a contract) the requisite degree of control over the sub-franchisees.
- Satisfy the franchisor that it has the energy, drive and commitment to make a success of the exploitation of the franchise system in the target territory within the framework of the agreed development schedule.

The franchisor will need to familiarise itself with the business issues which are of importance to the acceptability and success of the system with the target country. In doing so it must recognise factors which could impact upon what it does in its own country and for which allowance must be made. This does not mean inevitably that such a factor will have an impact - merely that it should be taken seriously and given proper objective consideration. Hostility to what makes things tick in the target territory will only make life more difficult for the franchisor.

We shall now consider some of these differences, some of which have been mentioned in the introduction.

- How does the market differ from the franchisor's home market or any other market in which it has experience? The franchisor may be forced to confront the issue of the market by law. For example, in France (see Chapter 8 for a broader discussion) in order to comply with the Loi Doubin the franchisor's disclosure document is required to make disclosure to the franchisee



of the market in general, the regional market and the specific market. The expression "the market" takes in a wide range of considerations.

- Those who sell the same or similar products or services - unless the franchisor is introducing products or a service which are new to the target territory. The former is much easier to assess, the latter much more difficult. The fact that there are those who sell the same or similar products does not mean that anyone can. For example in Germany there exists a strong guild system membership of which is essential in order to carry on certain types of business. The assessment of a market must be sufficiently wide to discover such arrangements where they exist and to assess whether they prevent or so restrict operations as to make franchising the particular business merely difficult but manageable, or impossible. The franchisor who takes the trouble to make its assessment thoroughly will be better placed in its negotiations with prospective franchisees.
- How the people live - what do they like - what do they dislike - what is their culture, indeed that may extend to social structures and mores - how may these affect the franchise system - what are their behaviour patterns and how might that affect peak trading times, staffing requirements and thus costs?

What are the costs involved in running a business in the target territory? How will apparent cost differentials affect the outcome. For example, if the franchisor looks at approximately 10% of gross revenue for rental costs, should it be excited if rent costs appear low or depressed if they appear high? The answer will in all probability be reflected by lower gross revenue where rental levels are low and higher gross revenue where rental levels are high. Staffing costs may be affected by add-on social security costs, labour laws and trade union intervention which in some countries can be considerable. (See legal issues below).

Are internal and external communication channels sufficiently good for the franchisor to communicate with its franchisees (whichever route is chosen) and if there is a developer or sub-franchisor for them to be able to communicate with franchised units?

Are there adequate reliable distribution systems in place to provide the supply channels which the franchisors or sub-franchisor will require? Communications and distributions systems may present difficulties in the most unlikely places but developing world countries have more than their fair share of problems related to the operation of such systems.

What level of "street knowledge" does the franchisor need in order to operate in the target country? This can affect the choice of method of entry as can the distance between the franchisor's home country and the target country.

Coping with language is a factor. No franchisor can expect to be able to recruit in his own operations those with sufficient range of language skills that it does not need to recruit as franchisees those with whom it can communicate in its language or at least the main international business language which is English.

Having considered the business issues the franchisor will need to consider legal issues which include the following.

### **1. Contract laws**

The basis upon which franchise arrangements are entered into are invariably contractual.

The law of contract will, of course, differ from country to country. The differences between the common law system and the civil law system are quite considerable. Under the former little is left to implication unless there is a law which specifically impacts part of the contract. Under the civil law system the codes imply terms in contracts depending on the nature of the transaction - some of these implied terms cannot be contracted out of.

One cannot assume that contracts can necessarily be entered into on the same basis from one country to another. Care must be taken before entering into any commitments to ensure that

the correct form and procedures are followed. Indeed one may find that it is possible to create a commitment where none was intended.

## **2. Legal status of the parties and the nature of legal relationships**

Quite apart from an investigation and assessment of the capacity in which parties can contract, particularly if one of the parties is an overseas company, consideration must be given to whether or not there are local laws which might result in the franchisees being regarded as an agent or employee of the franchisor. For example, in Dubai a franchise agreement is characterised as a commercial agency whatever the parties agreed and may have intended.

In most franchise arrangements, the parties go to great efforts to ensure the establishment of the franchisee as an independent contractor, to ensure that the franchisee has no power to bind the franchisor, and that the franchisee is not the agent or partner or employee of the franchisor. Laws such as those in Dubai can nullify such efforts and also introduce the possibility that not only will it be difficult to terminate the arrangement but that there may be compensation payable upon termination or otherwise at the end of the relationship.

There can be laws which can be interpreted in such a way as to regard the franchisee as an employee of the franchisor and not as an independent undertaking thus imposing upon the franchisor obligations, both to third parties and of a financial character in the form of social welfare contributions, which are not part of the normal calculations made, or considerations taken into account, when establishing a franchise scheme.

## **3. Government attitudes**

It is important to ascertain whether the government has an attitude towards franchising and to the import of knowhow and trade secrets (see e.g. item 12).

One should investigate government attitudes and existing policies because it may be possible to take advantage of special incentive schemes and grants, which can be available for cer-

tain types of business or industry or in certain locations. This could make the franchise venture more certain of success and more profitable from the point of view of the franchisor and franchisee.

#### **4. Competition laws (Anti-trust)**

The competition laws of the territory must always be considered. Many countries are now adopting competition laws, the stated objective of which is to make anti-competitive practices unlawful and thus stimulate competition. These laws are not directed at franchise transactions, but often affect franchising because of the generality of their application. In the European Union one should not be misled by the existence of anti-competition laws at the European level into believing that there are no such laws applicable in the member states which have independent national application.

Apart from the statutory regulation of competitive practices, there are the laws relating to contractual in-term and post-term restrictions on competition which are found in every franchisor's check list, which have to be investigated. In some countries such post-term restraints are not permitted.

Many of the practices inherent in a franchise transaction such as exclusive rights, tied sales, price fixing and other controls, are capable of being affected by competition laws; their effect must, therefore, be very carefully considered.

#### **5. Intellectual Property laws**

The expression Intellectual Property includes patents, trademarks, the right to prevent unfair competition/passing off, copyright, design rights and know-how and confidential information. It is necessary to investigate the law in the target country to verify how securely to deal with and protect those rights which are relevant for the franchisor.

Trademark rights are territorial in nature and will generally only provide protection in the country in which they are issued. The exception is the European Community trademark issued by the Community Trade Mark Office which has pan-European effect. A trademark may comprise a word, a logo or a combina-

tion of the two and in many jurisdictions may also include sounds, shapes and smells.

Copyright laws can offer some protection and its scope should be investigated.

Most jurisdictions provide a trader with protection against a competitor who unjustly trades on the reputation and goodwill of another. In civil law jurisdictions, this is usually in the form of an unfair competition law, and in common law jurisdictions, a passing off action. Essentially, the law is seeking to prevent one trader from carrying on his business in such a way that the consumer believes it is the business of another trader.

The Franchisor's know how, trade secrets and confidential information are of course fundamental to it and the effectiveness of the methods of ensuring their confidentiality and the enforcement both during and post the contractual term are not necessarily protectable in every jurisdiction.

## **6. Taxation**

The taxation effects on the franchise scheme have to be considered. There are two aspects. First there are taxes applicable to the operation of the franchise unit in the target territory. These may include:

- property related taxes
- sales taxes
- taxes imposed upon business profits, and whether payments of fees to the franchisor will be deductible from profits for tax purposes

There may be variations in accounting and reporting systems and procedures which the business and tax requirements in the target territory require and which have to be considered.

Second there are the international tax considerations. Franchisors will either wish to receive payments of franchise fees - that is initial fees as well as continuing fees (or royalties) without deduction of any sum in respect of local taxes (withholding tax) or to receive credit for such taxes paid when calculating its tax liability in its own country. In many cases this will not be possible. However one should investigate to see whether a dou-

ble-taxation agreement exists between the franchisor's country and the target country to see what is the effect. If there are no direct double-taxation agreements, or if the terms are not thought sufficiently beneficial, then investigation should be made of the best route from target country to the franchisor's country for the income of the franchisor to enable the effects of multiple taxation to be eliminated or at least minimised.

Very often careful selection of the route through which the monies flow by taking advantage of double-taxation agreements can achieve a great deal in ensuring that the maximum amount of money reaches its ultimate intended destination. There are also cash-flow considerations, and if withholding taxes are imposed to any substantial extent it can have an adverse effect on the cashflow of the franchisor sufficient to affect its ability to finance its operations from the income generated in the initial stages. There can be unexpected traps even in double taxation agreements where initial payments for the grant of rights may be regarded as advance royalty payments, or treated as if they were and thus subjected to withholding tax.

## **7. Corporate laws**

In deciding whether to set-up a branch or operational subsidiary, apart from the taxation implications of operating in this way, local corporate laws have to be considered to see what form of incorporation may be necessary, or desirable, or whether there are requirements for registration of foreign companies which establish a place of business. Some countries have prohibitions against foreign nationals owning the majority of shares in companies which are incorporated in their jurisdiction.

Corporate laws also need to be studied to the extent that franchisees may choose to incorporate the business which is to be operated under franchise. The franchisor will have to ensure that shareholders and directors cannot acquire the franchisor's know-how and trade secrets, and subsequently use them in competition with the franchisor.

There must be a clear understanding of the corporate laws,

and the roles, duties and responsibilities of shareholders and directors.

### **8. Special franchise laws**

The U.S., with its federal and state system, abounds in a multiplicity of laws affecting franchising. There are pre-contract disclosure requirements, registration requirements in some states (a minority) but not in others, and in some states laws affecting franchisors' rights to terminate or to refuse renewal of franchise agreements. So far as the U.S. is concerned, one can almost be offending against some legal requirement even in discussing the grant of a franchise. Legal advice at the earliest point, even before discussions which may lead to negotiations, is essential.

There are pre-contract disclosure laws only in France and Spain of the EU member states. In the UK there are laws which impact upon franchising, such as the Trading Schemes Act 1996 which would affect all systems unless they can benefit from one of the exemptions. The exemptions relate to single tier schemes i.e. those with one franchisor in the UK and franchisees (or one sub-franchisor in the UK and sub-franchisees) and those where all franchisees are registered for Value Added Tax.

There are also pre-contract disclosure laws in Brazil and Mexico as well as recently relaxed laws in the province of Alberta in Canada. Russia has enacted in Chapter 54 of its Civil Code a set of regulations affecting franchising which given the relatively tiny franchise community is not justified by commercial misconduct. In addition it contains provisions which make franchising less attractive. It appears that there is a real risk the other former Soviet republics will follow the Russian lead. It is understood that Kazakhstan and Kyrgyzstan are considering doing just that at the time of going to press. There was recently published in Italy a proposed bill for the regulation of franchising which has a number of adverse features. There have recently been enacted laws in Indonesia and Korea affecting franchising.

One of the problems confronting international franchising is

that as it spreads there are many legislators who believe that because it exists there must be legislation. Since the efforts they produce indicate that they do not understand the subject there are bound to be the difficulties which the laws in the UK (Trading Schemes Act), Russia, Indonesia and the proposals in Italy present to the growth of franchise systems.

Apart from these countries there are few countries throughout the world which have special laws which were specifically created with franchising in mind.

In Europe the accent has largely been on self-regulation and the European Franchise Federation has adopted a uniform code of ethics which the members of its affiliated national associations are bound to observe.

Australia is a country which has long flirted with some form of franchise regulation although its courts have demonstrated that the existing law provides franchisees with more than adequate remedies. The most recent development in Australia was the establishment of a body to self regulate franchising. This folded after the government withdrew its financial support and at the time of going to press the Franchisors' Association of Australia is trying to take on the role of the now defunct body. There is now a legislative proposal before the Australian federal parliament.

In South Africa there is a code of ethics which the Franchisors Association of Southern Africa has introduced which arguably has some statutory support.

In some countries (e.g. Austria) there is a filing requirement for competition (anti trust) law purposes.

## **9. Special industry laws**

The franchisor should investigate whether the target country has any laws which regulate the industry sector to which the franchised business belongs.

For example, fast food or restaurant businesses will invariably be affected by legislation which regulates standards of hygiene and cleanliness in the interests of public health. These requirements must be carefully checked out by the franchisor to ascertain the differences between the requirements of the law



in the target territory compared with the franchisor's home market. In the case of retail franchises there will frequently be labelling requirements which may necessitate their production in the language of the target countries amongst other requirements.

## **10. Property laws**

Laws affecting real estate and leasehold property vary from country to country and what may be permissible in one country may not be in another. In some countries, there may be protection for business tenants and in others there may not be.

Careful evaluation has to be made of property laws to see whether the manner in which the franchisor's scheme is structured in its home country is capable of being repeated in the target country. If it is not, adjustments may have to be made to take into account the differences and some fundamental re-thinking may have to be engaged in. This is particularly the case where franchisors wish to retain the ownership or control of premises.

## **11. Exchange controls**

Some countries have restrictions on the import and export of currency. It is necessary to ascertain whether such restrictions exist, and, if so, what they are and how the system works.

There may be a requirement that consent is obtained for inward investment, and that it is given only on certain conditions. These conditions may affect the right of the investor to remit profits in whole or in part. Careful evaluation will have to be made to see how these laws affect the franchisor's investment and its ability to receive payments for goods and services (including franchise fees) in its home country.

There is little point in selling know-how and granting rights to others to exercise the opportunity to carry on business under a franchise arrangement if it is a profitless exercise for the franchisor, in the sense that he is unable to turn his entitlement to income into cash in his hand except in the target territory where it may have little use for it. There may be scope for barter arrangements but to be effective these sort of arrangements

require a level of business to justify them.

## **12. Limitations on royalties**

In some countries often as part of the exchange control regulations, there can be limitations imposed on the rate of royalties, and whether or not royalties can be paid at all.

Certain countries take the view that low grade know-how and trade secrets should not entitle the owner to any royalty income. Some take the view that the royalty income should be limited for a period of time, after which no further charge can be made.

One is not speaking of franchising in any denigratory sense when referring to it as low grade know-how", but compared with high technology manufacturing industries the know-how which a franchisor develops for the operation of a service business is usually regard as much lower grade know-how.

Regardless of whether or not the franchisor is prepared to accept that its know-how is low grade, it is the attitude of the target country which is relevant. There are some which have very rough and ready guides which do not necessarily make sense when approached objectively. The possibility exists that the franchisor could well find that it is negotiating the fees with the government and not the franchisee who may well encourage the government to bargain very hard.

## **13. Zoning/planning laws**

It is necessary to investigate the extent to which there are any restrictions on the use to which premises can be put. Are there any building requirements or building regulations affecting the proposed fitting out of the premises for use for the purposes of conducting the franchised business? This difference between the franchisor's home and target countries can have a marked effect on the operation, the layout of facilities, and the rate at which the franchise network can grow.

It often transpires that when the calculations (sometimes optimistic) of growth rate made by the franchisor take into account the differences, coupled with the difficulty in obtaining suitable sites for particular types of business and zoning prob-

lems, completely different financial and development schedule projections emerge from those which the franchisor originally anticipated.

Regulations in the target country in relation to building may require a higher standard of construction than is normally built into the franchisor's capital requirement projections. Unless a thorough investigation is made of these factors, the franchisor is not in a position to give the right guidance to franchisees or, indeed, to know the extent to which its operation is viable.

#### **14. Employment laws**

There are wide variations in employment or labour laws, as well as a wide range of add-on costs to the employer, depending upon the nature and degree of social security payments required in the particular country. There can also be legislation which inhibits the ability of the franchisor or the employer to dismiss staff without being liable for compensation payments.

These laws must be assessed and realistic decisions made about how to cope with the differences which exist between countries.

Consideration may need to be given to whether there are immigration laws and/or work permit requirements which need to be complied with in order for the franchisor to make staff available in the target country.

#### **15. Excise and duties**

The cost of importing materials and equipment, and plant and machinery must take into account (apart from shipping costs) any excise or other duties which may be levied on them in the target country.

This, coupled with the need to make technical changes in equipment to which reference has already been made, may require the franchisor to use locally-manufactured products, or products manufactured in the same trading area to which the excise taxes and duties may not apply or may not bear such a high rate. If the franchisor is to provide the franchisee with products there may be import duties which are significantly high. If the franchisee is seeking to receive its income solely

from mark-ups on products the franchisee may find it is paying duties on the mark-up which may make it more difficult to sell the products in the target country and make a sufficient profit. Such problems require imaginative solutions.

### **16. Import/export controls**

Some territories have restrictions on what may or may not be imported or exported, and certain standards may be set which must be achieved before imports are allowed. There may also be quotas limiting how much can be imported from certain countries.

The franchisor must be sure that whatever it requires to import into a target territory, it must be possible to do so. Its product requirements must be capable of meeting the criteria established by the regulatory requirements in the target country in order to qualify for import, or alternative arrangements must be made.

### **17. Summary**

International franchising can have many rewards, but these will only be commensurate with the thoroughness with which the franchisor prepares to take this significant step.

In the same way as one is cautioned against nationally franchising prematurely just because the franchisee is available, one is also to be cautioned against franchising prematurely on an international basis. The pitfalls are just as great, and the risk is much greater that someone will steal their ideas and know-how, and establish better rights to them in the other country than one can establish.

## CHAPTER THREE

# Structuring the arrangements

HAVING taken the decision to operate in a foreign market, the franchisor then has to consider the method by which such an operation will be established. There are a number of different approaches which are commonly in use. These include:

- a company-owned only operation
- direct franchising
- a master franchise arrangement
- a joint venture.

The mechanism by which the chosen method is implemented may involve the franchisor in establishing:

- a branch operation
- a subsidiary company

### **Company-owned operation**

In this case, the franchisor establishes its own operation directly owned and run. In order to do this, the company would need to have the manpower and financial resources to establish and sustain such an operation which many companies do not possess.

It is a convincing way of entering a country since a successful company-owned network would, in the future provide the basis for the introduction of franchising should the franchisor wish to do so. Quite apart from the need to have the resources to establish a business in a target territory a franchisor may decide that to attempt to develop internationally in this way would be too slow since the number of countries which could be entered in this way would be quite low. One must also consider the point already made that establishing an international programme will require both financial and manpower resources - using them to open company-owned operations in one country

may prevent the franchisor from achieving the rate of growth which would otherwise be available to it. Using this method may face the franchisor with a number of business problems referred to in Chapter 2. These will include particularly:

- Recruiting and training local staff
- Adapting to the business methods, the culture and the language - the franchisor will inevitably need local people to provide the right direction in these respects - it cannot be done by remote control
- The problems of supervising and controlling the operations.

### **Direct franchising**

This will involve the franchisor in entering into a franchise agreement with each individual franchisee in the target country, and in providing the basic back-up and continuing support directly. As a technique it is normally limited in scope because the further away the franchisor is from the target territory, the more difficult it becomes to service the franchisees.

The use of the direct franchising route also makes the franchisor vulnerable to the possibility that it will fail to recognise the differences which exist between its home country in which the business originated and the target country. Pilot operations are advisable in order to achieve the transition.

For those intending to do business with or within the European Union it is relevant to appreciate that although much progress has been made in eliminating fully internal barriers which formerly existed that is to say those which are physical (e.g. the movement of people and goods), technical (e.g. product specifications, professional qualifications) and fiscal (e.g. harmonisation of tax rates), there will remain some vital differences throughout the EU. These will include:

- Language barriers.
- Local laws which could impact upon franchising, franchise operations, and agreements, although special industry laws should be increasingly standardised.
- Cultural and life-style differences.

- The tastes and habits of the inhabitants of the individual member states will continue to be different.
- National characteristics will not change at all.
- The need to adapt the franchise system to local conditions.

However much the politicians strive to regard the EU as one market the reality is that when one considers entry into one member state it will not follow that entry into another member state will be the same.

The territorial scale of the EU may make it more feasible for franchisors to consider the use of area development agreements. The use of area development agreements under which the franchisor enters into an agreement with a developer who will open an agreed number of franchised units within an agreed time frame within a defined area, is another form of direct franchising. There are some franchisors for whom this is the preferred route - some will have one developer per country - other will have a number of developers within a country. As a method of covering a country using direct franchising it can have some advantages in that there will be far fewer franchisees for the franchisor to deal with. On the other hand if things go wrong the problems can be spectacular and involve a large number of franchised outlets in the country or indeed all of them.

An example of the scope which the use of this technique presents is: - take country x where it is reckoned that the market would sustain 100 franchised units. The franchisor wishes to use direct franchising because it provides it with more control over operations and advertising than the other methods available. However it finds the prospect of dealing with 100 individual franchises somewhat daunting - it also believes that it would take a long time to reach critical mass and achieve the level of market penetration which it would like. It therefore decides to seek 10 area developers each of whom would be required to develop 10 franchised outlets. The Franchisor believes that by only having 10 franchisees it will be able to use its resources better in assisting them to become established; it will obtain franchisees of a higher calibre who will be able to introduce

substantial resources and obtain prime locations without the difficulties often encountered by individual franchisees; and will be able to train each franchisee's team to train their managers and staff. In terms of control and the expenditure and generation of advertising it will be better placed only having 10 franchisees which whom to deal. It accepts the risk that one mistake can have a disproportionate adverse impact and that it may be difficult to cope with the problem of dealing with 10 failed units if one of the developers for whatever reason fails to succeed.

There are other dangers since it is easier for a smaller group to pool resources and "take on" the franchisor particularly if they are discontented with the franchisor's performance and are contemplating breaking away from the franchisor's network. As the franchisee will be of a different calibre from the individual franchisee it will tend to be more confident of its own knowledge and ability which may present the franchisor with different forms of control, management and people handling problems from those with which it is more familiar.

### **Master franchise arrangement**

Under this arrangement the sub-franchisor will have the right either to open its own outlets or to sub-franchise, or do both. The emphasis will be on sub-franchising and the sub-franchisor will be expected to establish its own outlets to pilot test and to have examples to demonstrate successful operations to the prospective sub-franchisees. The sub-franchisor, in essence, stands in the shoes of the franchisor in the territory and is to all intents and purposes the franchisor of the system in the territory.

As is always the case, there are advantages and pitfalls. The franchisor has to consider the following.

- The difficulties in identifying and selecting the right person or company as sub-franchisor.
- The need to have a strong home base to sustain the demands which will be made upon the franchisor.
- The diversion of manpower and financial resources from



the domestic operations. It must again be emphasised that it will always take more people and cost more money than one would anticipate.

- The time factor: it will also always take much longer than one anticipates it might.
- The franchisor has only one entity with which to deal in the target country. All its dealings will be with the sub-franchisor and it will not be concerned in the day-to-day direct dealings with the sub-franchisees who operate the outlets. The similarity with domestic operations where the franchisor is not concerned with the day-to-day problems of the franchisee's operations is not coincidental. However, the franchisor must not ignore the sub-franchisees - they are the lifeblood of the network and the quality of their operations will either bring credit to the franchisor's name and system or harm its reputation.
- The quality of the sub-franchisor's services in the selection and training of sub-franchisees, site selection, and all the other services he provides to his sub-franchisees is vital. The franchisor needs to be satisfied that the sub-franchisor will ensure that these services are provided to the requisite standard, and it must have an interest in the ongoing controls and the supervision of standards which the sub-franchisor will provide. The neglect of these areas will mean that the franchisor may find itself with a sub-franchisor who will probably have to be terminated and a troublesome sub-standard sub-franchisee network to be coped with. The maintenance of standards and the control of the quality of the network's operations is crucial and difficult to maintain and its achievement is regarded by many as one of the fundamental problems with master franchise arrangements. It is therefore important to recognise that this is an issue both to be confronted and to be dealt with in the contractual arrangements.
- The franchisor should make some effort to attend sub-franchisee meetings organised by the sub-franchisor and encourage foreign sub-franchisees to attend the franchisor's franchisee meetings in its domestic market at least on an annual

basis. This form of contact, together with the normal regular "quality control" visits, will demonstrate to the sub-franchisees that the franchisor is indeed interested in them and that they are part of its global network and family of franchisees. The franchisor, however, should never put itself in the position where it risks being regarded as usurping the functions of the sub-franchisor so long as the sub-franchisor is running the operation correctly. There is a balance which has to be maintained which will not lead to sub-franchisees playing off the sub-franchisor against the franchisor.

- In the same way as the franchisor operating in the domestic market expands his network using the resources of its franchisees so does the franchisor under the master franchise agreement. Indeed, he does it at two levels instead of one. At the one level, the sub-franchisor will be required to provide the financial resources to establish and exploit the system in the target country. Whatever financial resources are needed to establish the system and operate it in that country, they will have to be found by the sub-franchisor. Part of the franchisor's selection process will involve an assessment of the sub-franchisor's financial resources. Additionally there will, of course, be the other level - the operation of the outlets for which the financial resources will be provided by the sub-franchisees who are operating these outlets.

- The sub-franchisor should, of course, be making his own financial calculations to see whether he considers the proposition to be financially worthwhile. There will be some discussion in a later chapter on the piloting of operations which is necessary, but decisions will have to be taken during the course of the negotiations as to the nature and extent of pilot operations, as well as what contribution will be made to their establishment by each of the parties. The sub-franchisor will be responsible for the recruitment of staff for the pilot operations, as well as for the establishment of the sub-franchisor's own business organisation.

- The arrangement encourages the blending of the franchisor's

developed system with all the relevant factors to which reference has already been made, which are to be found in the target country by the application of the sub-franchisor's local knowledge. This sort of knowledge cannot be acquired sufficiently quickly by a "visitor" to the target country. The local businessman will have the basic knowledge and experience of local business practices, the law affecting business, banking and financial sources, and may be able to assist the franchisor to identify potential suppliers of products or services who may be suitable for approval as suppliers to the local network.

- A franchisor in a domestic operation will earn less in cash terms from a franchised outlet than it would from its own operational outlet. This is also the case with master franchising when the fee income generated by sub-franchisees is divided between franchisor and sub-franchisor. The sub-franchisor will be charging franchise fees to its sub-franchisees and from these fees he will not only have to finance his own operations, but also to make a payment to the franchisor. What that fee will be, and how it is calculated will be a matter for negotiation. It is unlikely that the fee charged to sub-franchisees in the target territory will differ much from that charged to franchisees in the franchisor's domestic territory so the amount available to be shared will be limited. There will be a discussion of this issue in the chapter which deals with the financial aspects.

- Mention has already been made of the vulnerability of the franchisor to any fall in standards of the network run by the sub-franchisor. The franchisor must, therefore, develop a strategy for the establishment and maintenance of the correct quality standards. This may be achieved by a combination of the continuation of training through imposing requirements in the contract, inspection visits, sanctions and general alertness by paying attention to the market place. There will for example probably be feedback from disgruntled sub-franchisees but while this cannot be ignored the franchisor cannot risk its relationship with the sub-franchisor without involving him in investigating whether the feedback is an accurate reflection of a

real problem or issue or a sub-franchisee trying to create problems for the franchisor - that would not be unheard of.

- The problems which arise when the franchisor feels that he has no alternative but to terminate the sub-franchisor are many and varied. It is likely in such circumstances that the franchisor will inherit problems because termination will either result from the sub-franchisor having done his job badly or because he is not doing very well financially and has neglected the network. Franchisees always find a change of ownership in their franchisor to be troubling, but often in a master franchise arrangement there are mixed feelings. On the one hand, the sub-franchisees may be pleased that the franchisor (the fountain of all knowledge and innovation so far as the system is concerned) has taken over the reins, but, on the other hand, there will be a feeling that perhaps it should have been done sooner and that they have in some way been let down. There will invariably be a level of hostility and resentment from some sub-franchises who may well be supported by many fellow sub-franchisees. There is likely to be a "can of worms" and the issues may well include mishandling advertising contributions made by franchisees.

Whatever the problems are the network will have to be carefully listened to and handled. Sympathetic treatment of their complaints must be seen to be available - although the franchisor may also be a victim of the sub-franchisor's failures it is unlikely to find any sympathy from the sub-franchisees. Most franchisors can expect an attrition rate whatever steps they may take.

### **Joint venture**

It is not the purpose of this chapter to consider the advantages and disadvantages of joint venture arrangements, but only the issues which are particularly relevant to franchising. The franchisor which enters into a joint venture will still find that many of the problems we have discussed will exist. The need to identify and do a deal with the right person is just as much of a problem. But there is more to it than that. The franchisor will

have to negotiate what share it wishes to take up and decide how it will finance its contribution. The joint venture company will become either an area developer or a sub-franchisor of the franchisor's system and will have to enter into the appropriate development or master franchise agreement with the franchisor. There may be particular reasons to consider a joint venture as many companies did when contemplating the post-communist era in Central and East European countries. Those countries provided tax incentives and liquid capital was not readily available to even established state or previously state owned businesses, although they did have assets often related to their occupation rights to the buildings in which they were trading. In some instances, the franchisor's contribution to the share of the joint venture has taken the place of the front-end fee normally payable, and on occasions the front-end fee is paid, but returned by the franchisor to the joint venture as its contribution. Sometimes a value prepared by a professional valuer is placed on the services provided by the franchisor and this value is taken as the measure of the franchisor's contribution to the capital of the joint venture.

The joint venture company will establish the system in the target territory on a shared basis with the local partner. It will be as involved in all the issues as if it were not part owned by the franchisor. The franchisor will however find that it has become involved in the risk of operational losses which it would otherwise have avoided and perhaps the need to find or assist in finding additional capital. It will also find that there is much scope for disagreement on operational matters with joint venture partners who will resent the fact that the development or master franchise agreement will give the franchisor (a joint venture partner) the last word on many such issues. This highlights the two roles which the franchisor has in this type of arrangement and which create scope for friction in the relationship.

Finally, the franchisor which is confronted with a buy-out situation, or the need to terminate the joint venture, the development agreement, or the master franchise agreement, will find itself in a potentially difficult position. The joint venture part-

ner will be established in the territory in operational control, and locally in command of the situation. The franchisor needs to have already established a presence in the territory, or the ability rapidly to put the right person or team in position (which will be rare), or it will be at a considerable disadvantage in trying to take over the operation or assert control.

It is infinitely more difficult to divest oneself of an unsatisfactory joint venture partner than it is to terminate a developer or a sub-franchisor (not that the latter is an easy option). To have to face the prospect of coping with both at one and the same time is something to contemplate long and hard.

Many refer to Branch operations and Subsidiaries as if they were methods of franchising internationally. Of course they are not - they are ways in which a franchisor may choose to formalise a presence in a country or region.

### **Branch operation**

The establishment of a branch operation can arise in two sets of circumstances where:

- the franchisor franchises direct into the target territory and has established a branch operation to service franchisees, or
- has established the branch as a regional base to provide services to franchisees within the region.

Whether or not a branch is established may well be affected by fiscal or legal considerations, rather than those of the business. These considerations may lead the franchisor to follow the next course available to him, the establishment of a subsidiary.

### **Subsidiary company**

The involvement of a subsidiary company may fulfil any of the following four functions.

- The franchisor could be franchising directly from his territory into the target territory and use the subsidiary to service franchisees.
- The franchisor may grant master franchise rights to the subsidiary (see below), and the subsidiary will be either

opening its own operations or sub-franchising, or both.

- The subsidiary may be involved with a joint venture partner (see later in the chapter).
- The subsidiary may be used as a regional base, either to provide services to sub-franchisees, or to sub-franchisors in the region.

The service which the branch or subsidiary would provide would be similar in nature to those provided by the franchisor and would cover the whole range of franchisor services, including, as the network develops, a training facility.

The correct choice of partner and type of arrangement, as well as properly structured and drafted legal documentation are absolutely essential in international operations.

## CHAPTER FOUR

# **Direct franchising and development agreements**

DESPITE the difficulties which direct franchising presents in terms of local knowledge and language some franchisors use this technique. There are a range of businesses which use the franchise marketing method ranging from those whose businesses thrive by a massive presence to those whose businesses are aimed at the luxury brand segment of the market place. In the former case the level of resources available may make direct franchising, often using a subsidiary, a very viable proposition. In the latter case the franchisor's strategy may only involve opening "flagship" outlets in selected markets - in some smaller countries perhaps only one. Between these two extremes there are many businesses which cannot afford to franchise direct or to be so selective so far as opening outlets is concerned. They will probably need to achieve certain volumes of sales in the foreign operation to make it worthwhile. There are also businesses based on specialist skills which require an innovative approach which may blend many of the available techniques without fully adopting any of the recognised categories. Some have an approach which is tailored more to the particular market and use one technique in one country and another in a different market. One must always retain the option of flexibility.

The technique of the development arrangement has as its intention the more rapid growth of the network; it is widely used in the USA market and increasingly in international transactions. There are many similarities between this technique and that of international master franchise agreements. The basic approach creates an arrangement in which the developer is given the right to open a multiple number of outlets to a predetermined schedule and within a given area. In some arrange-



ments which are called development agreements there may be a right to sub-franchise to some franchisees. This is of course much closer to a Master Franchise agreement - there are regional Master Franchise agreements which provide both options.

The Area Development arrangement in domestic markets is usually only employed in large countries; it is effective in countries which cover a large area but with few significant concentrations of population. Development arrangements are not commonly found in the UK although one significant franchisor in the convenience store business has a Regional Development Company programme.

There are the issues for a franchisor to consider in expanding through area development agreements which are equally applicable in domestic and foreign markets.

- As is the case with the franchising of individual units, the franchisor will be making use of the financial and manpower resources of the franchisees. However, an area developer needs more resources because it will be opening a number of franchise units. If the cost of opening an individual unit is, say, £100,000 and the developer has undertaken to open 25 outlets it will need to find, at least £2.5m to meet its obligations and within a given period of time.
- The £2.5m is not the whole story of course. The developer will need to develop a business infrastructure because it will need a "Head Office" organisation; its staff will have to be recruited and found. Premises will have to be found, professionals retained and fees paid. It will take time for the business to build up and break even reached. There may quite easily be another £.5m to £.75m required in terms of financial resources. One may be able to plan for the possibility that once profitability is achieved the profits may be ploughed back so that the total capital requirement is reduced.
- The financial resources of the area developer will therefore have to be geared up to permit the rapid growth of the required number of outlets so as to obtain the maximum benefit from the rapid saturation of its marketing area and the utilisation of the

organisational infrastructure which it will be creating.

- With the nature and extent of resources which will be required and with the commitment which will have to be undertaken, the area developer will have to be far more experienced in business than an individual unit operator. The selection process and the criteria to be applied in the case of an area developer will be very different from those which apply to the selection of unit operators.

- The fee arrangement in respect of the grant and exploitation of development rights would invariably fall into one or more of the following four categories.

- A lump sum payment to secure the development right to open an agreed number of outlets. This payment, in some cases, may be treated as a payment on account of the initial franchise fees to be paid in respect of each outlet, or it may be a payment totally unrelated to initial franchise fees. (The receipt of such a front-end payment can provide a franchisor with a welcome cash injection.) A franchisor in structuring the fees should bear in mind that the larger the initial fee to be paid the greater the cost to the franchisee in terms of interest and the longer it will take it to reach break even. The discussion of fees in Chapter 6 has some relevance and should be reviewed.
- An initial franchise fee to be paid on the opening of each outlet at the same rate as applies to individual outlet operations. These may be discounted (see above) by an agreed amount to reflect the fact that a lump sum payment has been made for the development rights.
- Continuing franchise fees.
- Advertising contributions.

In the case of both of the latter fees the franchisor will expect to receive the same as it receives from individual unit operators.

One can expect the developer to claim that the fees should be lower since there will be so many outlets to be in operation and that since the area developer will have its own management

structure, the franchisor will have less to do in return for the fees. Superficially this is an attractive argument and indeed there may be some saving in this respect, but it will more often than not be less of a saving than might be suggested.

A franchisor should on the other hand not expect that it will be able to provide less in the way of services to an area developer than to an individual outlet operator. All the normal range of services will have to be provided, as will periodic visits from field support staff to ensure the maintenance of standards and quality of operation, as well as providing assistance with problems, either on site or at the area developer's central office.

Furthermore, if an area developer encounters problems they will be much more extensive than will be the case with an individual unit operator. The franchisor will find disproportionately heavy demands upon its resources with which it will find it difficult to cope economically. A franchisor who has accepted lower fees from a developer and scaled down its support capabilities will be caught out when there are problems. Resources taken on to service the other franchisees paying full fees will have to be diverted to the developer with problems. This leads to a situation in which the other franchisees are in effect subsidising the area developer. In the case of advertising contributions, an area developer may argue that as in aggregate its contribution is disproportionately high it should have some concession. Any such concession would inevitably mean that those who did not benefit from the concession would be making a proportionately higher contribution to the aggregate spend which they would resent. Also, it is sometimes argued that part (if not the whole) of the area developer's contributions should be concentrated in its marketing area. This, of course, is what every franchisee would like and, if followed, would result in a loss or watering down of the benefits of co-operative network advertising and promotion.

**The fundamental principle that franchisees should be dealt with on an equal and consistent basis must be observed even where there are area developers involved in the network. Special cases make for discontent and resent-**

ment.

- While in theory, it should be easier for the franchisor to control the network operated by an area developer, the reality may well be different. Of course, the area developer will have its own management infrastructure and it will be wanting to ensure that all outlets operate the system properly and that full advantage is taken of the opportunities to develop the business. But, while the area developer and some of its senior staff may well be extremely well motivated through capital investment and share option schemes, each outlet will be, in fact, under management, and that management has to be provided with the right degree of motivation and supervision.
- The franchisor still has a responsibility to ensure that everything which should be done is being done at both levels. Care must be taken to ensure that the franchisor is not caught between an area developer, who refers it to an outlet which is in need of assistance, and the manager of the outlet, who blames the area developer for all his problems, or who will not accept direction from the franchisor unless the area developer agrees and so directs him.
- The area developer should have, or will acquire, a broader based local knowledge, extending throughout the whole of his marketing area which should enable him to capitalise upon the opportunities. There will be greater scope than exists for individual outlet operations, given the larger area, for a comprehensive saturation of the marketplace and the benefits from the greater concentration of exposure which will be obtained in the market area.
- The area developer's own business organisation should provide substantial back-up to the franchisor's efforts. Since the area developer's presence at each outlet will be staff and not an owner, the need for supervision will be greater and so will the need for constant training and re-training, as well as the recruitment of personnel. The area developer will have to provide these facilities in some respects as an addition to the services provided by the franchisor. The area developer will not be

replacing the franchisor in the areas of training and supervision, but will be able to provide these services more economically, given his scale of operation, than can each individual outlet operator. The area developer will have to bear in mind that it will need to have these resources available or it may not be able to ensure that it can perform its contractual obligations to the franchisor.

### **Contractual documents**

The franchisor who seeks to benefit from the advantages of offering area development agreements will have to face the burden of complex contractual and structural arrangements. There will invariably be two, and possibly three, contractual documents.

#### **1. Development Agreement.**

This will have two distinct aspects. First it will contain detailed provisions in relation to the development programme and the procedure for selecting and approving locations. Second the detailed infrastructure to be established by the area developer; the area developer will have to undertake certain central obligations in terms of business organisation and functions. Its senior staff will have to undergo specific training, and it is likely that the franchisor would require that the person who is appointed managing director (general manager) will have to be approved by the franchisor and to have passed the training course. In addition it is not uncommon to find a requirement that the managing director (general manager) should have a minimum equity stake in the business.

#### **2. Operational unit agreement.**

This will usually be on the same basis as that used for individual unit operators adjusted to avoid unnecessary overlap with the Development Agreement. The operational unit agreement will be signed when each location is approved at which time any initial fee will also be payable.

#### **3. Funding agreement.**

Unless the area developer has considerable resources it is possible that, in addition to the above agreements, that there

will also be a funding arrangement. Funding may be provided by anything ranging from one investor, a syndicate of investors to a venture capital fund. Apart from the conflict which is at the centre of every franchise arrangement the involvement of any third party investors creates more scope for conflict and tension. Franchisor and franchisee see a common purpose in their relationship while a third party funding source will not be viewing the arrangement in the same way as a franchisee. The investor will be looking for a return in terms of income and a capital gain with a secure exit route. It will not necessarily be that interested in the principles of franchising and may expect the franchisor to submit to its demands which of course the franchisor cannot do. This approach is not uncommon but the investor has to appreciate that the investment is being made in a franchised operation and that such operations are not tailor made to investors' requirements. There is another factor which is that the franchisor is not in a relationship with the investor at that stage. There are two relationships - one between franchisor and franchisee and the other between the franchisee and its investors. The investors have to accept if they want to invest, that the franchisee is operating as part of a franchise system to which it will have to conform. Depending on the size of the investment it may be necessary to factor in the possibility of the franchisee's shares being listed on a stock exchange to provide the investors or venture fund with an exit route.

The investors will otherwise have to accept that if dissatisfied with the working partner they may have to convince the franchisor of their case since the franchisor may consider the partner is doing well. They will also have to accept that any sale of the franchised business (other than a market listing) will require the franchisor's approval.

### **Structuring the area development agreement**

There are a number of problems to be considered.

- What are to be the number and density of the outlets?
- Are exclusive or non-exclusive rights to be granted?
- Will the area developer be limited to opening the number of

outlets agreed upon in the contract, or will it be permitted to open more? If so, on what basis?

- What degree of transferability will there be? Will the area developer be permitted to dispose of his right to develop the area? That would be unusual as most franchisors would expect an area developer to complete the development schedule before seeking to sell the business. The franchisor is essentially seeking a relationship with those who will develop the area and who will have been selected for that purpose. The franchisor would not expect the area developer to enter into an area development agreement in order to profit from its sale and thus not be involved in the crucial development stages of the system for which purpose he was expressly recruited. Such a course of action would be fraught with problems which may extend beyond the relationship between the franchisor and its developer; they will undoubtedly involve also its investors and venture fund who have put up the funds for the area developer's business. One cannot of course rule out the possibility that pressure for a sale may come from the investors or venture fund who believe they can find a quick profitable exit route.

Would the franchisor really want to permit a change, before the network is fully in position, in the person who has negotiated the development schedule and who is, in reality, the person to whom the franchisor is looking for performance. The break in continuity may prove a stumbling block and the individual may be difficult to replace. A change may also result in difficulty being experienced in meeting the development schedule. The area developer's team of senior executives may well lose interest if the person who recruited and motivated them is to depart before the development phase is complete. On the other hand, those who have provided the financial back-up will not want to be prevented from changing that person if they have lost confidence in his ability to take the business forward effectively. (The possibility of the conflict arising has already been mentioned). These are all difficult matters which will have to be considered and common ground found in the course of nego-

tiations.

Again, it is necessary to emphasise that in structuring these arrangements, the fundamental features and requirements of a franchise transaction must be maintained no matter what pressure the area developer and its funding sources try to impose. Once the integrity of the franchise concept and system is undermined, the future development of the franchise is put at risk. As is the case with individual outlet operations where uniformity of treatment is essential, so it is with area developers - once the format for dealing with area developers is established it should remain the same for them all.

■ To what extent will the area developer be permitted to dispose of individual units without affecting the development right and on what conditions? Bear in mind that each unit operated by the area developer should be on the same contractual basis as those operated by individuals. The issue is not whether the area developer can sell individual units, but whether it can do so before it has fully developed the schedule (as required by the contract) or if it does so thereafter, must it replace the outlet sold with another - if so, on what terms? The issue of the possible advisable closure of a non-performing unit will also need to be considered. There may be many reasons for non-performance which include a site selection error of judgment; redevelopment in the area or reorganisation of traffic flows.

■ When one considers the problem of termination of these arrangements, the position becomes even more difficult. There are three possible arrangements to terminate:- (a) the development right, (b) the whole agreement, and (c) individual outlet agreements. Let us consider each in turn.

**The development right.** This would normally be capable of termination in the event of a failure to perform the development schedule. If the area developer has exclusive rights, does it merely lose its exclusivity? Whether or not it has exclusive rights, does it lose the right to continue to exploit the development schedule in the future? If so, are there ways in which it



may be able to protect itself against a slower rate of progress than it had planned and committed to? These are issues to be considered. One should remember that the franchisor will attach great importance to the maintenance of the development schedule and may feel that the failure to do so would operate too much to the detriment of the development of the network in the target territory. Whichever way the franchisor decides to approach the problem there is no clear answer. At the worst the franchisor would have parallel systems being operated by the original area developer and one subsequently appointed. The practical problems which can arise in such circumstances where there are in essence two developers within a given territory may lead some franchisors to require that the defaulting developer should be capable of being terminated for a failure to sustain the development schedule. (There is discussion of this issue in relation to Master Franchise Agreements in Chapter 5).

**The whole agreement.** This would apply where there is failure by the developer to observe and perform the "nondevelopment right" provisions in the development agreement, i.e. the detailed infrastructure referred to earlier (see above under the development agreement). One would normally expect that such failure would not lead to termination unless the developer had been given an opportunity to put matters right. However, given that despite warnings and in the face of a failure to remedy the default, the franchisor terminates the agreement, one would expect such termination to bring the development agreement to an end, including the development right. This would have to be the case, since if the general provisions relating to the area developer's business structure are ignored it would be futile to permit it to continue to develop by opening further outlets. Similarly, such a breach would also be expected to lead to a position where the individual outlet agreements would also be capable of being terminated since the business structure, designed to provide the basis for the supervision and control of those outlets, would not be in existence. Apart from the other issues, there would in any event be a hiatus so far as the contrac-

tual provisions are concerned.

**Individual unit agreements.** One might expect that there could be problems with individual units which could lead to termination of the agreement relating to such an unit. Whether or not that termination should affect the main agreement must depend upon:

- why the agreement is terminated, and
- how many of such agreements are terminated within any given period of time, and
- whether or not the breach of the individual unit agreement involved a sufficiently serious breach of the main agreement.

One then has to consider what should be the consequences of termination of each of these three agreements.

- Does the loss of the development right affect the continued operation of the individual outlets, and if not can the developer still apply to open new outlets, but independently of the development arrangement? What would be the consequences if it did?

- If the whole of the development agreement is terminated, should the individual unit agreement also be in jeopardy (see above)?

- One would also expect that all the normal consequences of termination of a franchise agreement would be equally applicable. In cases where the franchisor has an option to purchase on termination, the scale of the business to be purchased could cause problems for it because the amount of the money involved could be considerable particularly if there is a premium value in the real estate occupied by the developer for the purposes of the business.

### **Further considerations**

So much for the complexity of the contractual and structural arrangements, but there are also other important issues for the franchisor to consider when entering into area development agreements. Some have been raised already but they are important enough to warrant inclusion in a summary of this nature.

- Entry into development agreements has to be handled with great care so that a proper balance of power is maintained between the franchisor and his franchisees. A franchisor with, say, four area developers covering the whole of the UK and with no other franchisees is clearly vulnerable to challenge. Each of the area developers will represent a substantial part of the franchise, and if two or more "gang up" on the franchisor it could be in great difficulties, unless it has considerable resources. A franchisor should, therefore, never structure its arrangements so that it is creating a franchisee network where the franchisees or a small group of franchisees could have such power that it is at a serious disadvantage. A balance must be maintained between single unit operators (or company-owned units) and area developers so that the franchisor has a powerful business base from which it can operate without a threat with which it cannot cope through lack of resources and the ability to manoeuvre.
- Having chosen to select area development as an expansion method, a franchisor is committing itself to that one person to exploit an area and open a number of outlets, consistent with the size of the area. If the area developer does not proceed at the agreed rate of openings, then the growth of the franchisor's network will be inhibited. It may be difficult later on to regain the impetus and put the network back on course.
- If an area developer proves unable to cope, the problems for the franchisor will be that much greater, depending upon the size of the area developer's operation at the time when the problems arise. Dealing with individual unit operations which experience difficulties will always be part of life for the franchisor, but normally those operators will only represent a small percentage of his network. Dealing with the area developer, whose operation has gone sour, will probably involve all the area developer's outlets, which in aggregate will be a larger percentage of the whole, and these problems will have to be coped with in addition to the normal volume of problem cases from individual unit operators.

- These factors emphasise the need to ensure that the developer's management team is of the right quality (see also below).
- The existence of a large organisation as a franchisee, with the likely transient nature of its employees, makes it more difficult for the franchisor to protect the spread of its know-how and confidential information. Care will have to be taken by the franchisor to ensure that the correct steps are introduced to protect its know-how and confidential information from unauthorised exploitation.
- The elements of motivation and incentive at operational unit level, which are important fundamental features of franchising, are considerably diminished because the outlets are operated not by franchisees but by managers. The supervisory ability of the area developer's management team, and the existence of incentive schemes are, of course, valuable aids to the solution of this problem. It is, therefore, vital that a way is found to provide incentives and motivation at outlet level, as well as operational supervision and to encourage the stability and long-term loyalty of the management staff.
- The introduction by the development agreement system of a layer of management between the franchisor and the operational unit staff can create difficulties. The franchisor must be in the position of being allowed to intervene at the operational unit level if standards are not maintained.

Area development arrangements present challenges as well as benefits. However, the issues which they raise have relevance also in other "multiple franchisee" arrangements, such as the situations in which a franchisee through his ambition and ability becomes the owner and operator of a significant number of operational outlets.

## CHAPTER FIVE

# Master franchise agreements

BEFORE considering the provisions which one can expect to find in an international master franchise agreement, it is advisable to delineate the functions and purposes of the arrangement as well as the consequential requirements.

The master franchise agreement will reflect the commercial bargain which has been struck by the franchisor with the sub-franchisor to:-

- introduce the franchisor's system to the target territory,
- evaluate the viability of the franchisor's system in the target territory,
- equip the sub-franchisor to become the "franchisor" in the target territory,
- develop the growth of the franchisor's system in the target territory, and
- result in the sub-franchisor providing the full range of franchisor's on-going services to sub-franchisees in the target territory.

It should be understood that in these transactions the aspirations of the parties and balance of negotiating power will vary from case-to-case, as will the skills, financial resources, knowledge and experience of the prospective sub-franchisor.

Negotiations for these agreements are prone to failure for the following reasons.

- The franchisor's initial fee requirements require the payment of a sum which bears no resemblance to the reality of the prospects for the business in the territory or the value of the services and know-how which are being provided. (See Chapter 6).
- The franchisor requires payment of too high a proportion of the continuing franchise fees which sub-franchisees will be

paying to the sub-franchisor. (See Chapter 6).

■ The prospective sub-franchisor (and this is particularly the case where it is a large company) cannot come to terms with the conceptual issues involved in franchising on this basis and the controls to which it will inevitably be subjected. Whatever the nature of the agreement, the fundamentals of franchising do not change and cannot be compromised however much of a culture shock they may be for the prospective sub-franchisor.

■ The prospective sub-franchisor has underestimated the capital requirement and the time-frame involved before the operation will generate profits.

■ The franchisor will not accept the need to consider if, how, and to what extent the system and manuals require adjustment to the business, legal and other relevant factors (including the market realities) which are to be found in the target territory.

### **Structure of the master franchise agreement**

The master franchise agreement will have to accommodate the issues which the commercial discussions will have confronted. In many of these issues, there is no such thing as the right answer since these agreements unlike unit agreements are all negotiated.

**However, the fundamental principles must remain, as is the case throughout all franchise transactions. It is necessary to emphasise, yet again, that in structuring these arrangements the fundamental features, characteristics and requirements of a franchise transaction must be maintained. Once the integrity of the franchised concept and the system is undermined the future development of the franchise is put at risk.**

The main issues to be dealt with in negotiating and preparing master franchise agreements are as follows:-

1. The rights to be granted and the Term
2. Territory
3. Exclusivity
4. Performance schedule, piloting, adapting the System

5. Franchise fees (see Chapter Six)
6. Withholding tax and gross-up provisions (see Chapter Six)
7. Training
8. Advertising (see Chapter Six)
9. Trade marks and other industrial and intellectual property
10. Sale of the sub-franchisor's business
11. Protection against misuse of know-how and unfair competition
12. Default issues
13. Post-termination consequences and requirements
14. Choice of law and forum

We shall now look at each of these subjects in turn.

**1. The rights to be granted** These will always include the use of the franchisor's trade marks, service marks, trade names, know-how, confidential information, copyright material and all the usual elements which one finds in franchise transactions. The nature, extent of the rights, and the obligations attached to them are dealt with separately later in this chapter. The length of the term for which the rights are granted must also be specified.

The agreement of the length of the term does not usually present too many problems in negotiation. However, the author has seen drafts with what is clearly an unrealistic five-year term proposed. Since the nature of the transaction involves establishing the sub-franchisor as the franchisor in the target territory with a corresponding investment, the longer the term, the greater the opportunity to develop the territory properly. With a five-year term, in many cases a sub-franchisor would have a shorter term available to him than the sub-franchisees would expect. That is clearly unworkable.

The clauses in the contract which will deal with these issues will have to recognise and cope with the problems involved in the grant by the sub-franchisor of a longer term to sub-franchisees than the sub-franchisor has left under its agreement.

This can happen sooner rather than later if the sub-franchise agreements are for a 10-year term since any sub-franchise agreement granted after 15 years where the master franchise agreement is for 25 years will create a problem unless the issue is dealt with properly in the master franchise agreement. The more realistic terms are from 25 to 50 years with rights of renewal. The safeguards for the franchisor will be in the performance criteria which are laid down for the development of the network and the control mechanisms and their enforcement should it become necessary.

Assuming that it is agreed that the sub-franchisor should have a right of renewal there will be the normal issues to consider. In what circumstances should the right of renewal be denied? On what terms should it be granted? Will there be scope for the franchisor to introduce changes to the contractual terms. It is common in unit franchises to provide that on renewal the franchisee and the franchisor will enter into the form of franchise agreement being offered by the franchisor at the time of renewal. Since master franchise agreements are individually negotiated a more flexible approach needs to be found in such cases. One must bear in mind the likely time-scale since the original master franchise agreement was entered into.

Will any charge be made for the extended rights which are to be granted and if so how will the charge be calculated? Leaving it to be negotiated at the time the right is exercised could effectively leave the sub-franchisor with no rights at all since if the charge cannot be agreed there could be no contract. What will be provided for as the on-going development schedule? How will one cope with changes in the method of exploitation of the franchised business, e.g. one could find larger regional franchise units with satellite operations instead of smaller stand-alone units. This could have a dramatic effect on the number of outlets which are required to be opened and kept in operation, even though turnover may be enhanced.

**2. Territory** As is the case with operators of individual units who seek the comfort of territorial rights, most sub-franchisors



also seek the widest possible territorial rights. In agreeing the extent of the territory to be exploited by the sub-franchisor, regard clearly has to be paid to the franchisor's overall international marketing strategy and how each of the individual sub-franchisors will fit into the pattern of that strategy.

Ideally, the territory should be one in which the sub-franchisor has the knowledge, experience and capacity to cope. One of the reasons already stated for master franchise agreements is to have the sub-franchisor stand in the shoes of the franchisor in relation to the marketplace. It somewhat defeats the objective of the exercise if territories are granted of such a nature and/or extent that the sub-franchisor is not capable of achieving proper exploitation. The question of exploitation and the degree of exploitation will be dealt with later, under the heading of performance schedules.

Care should be taken not to add on a nearby territory merely because the sub-franchisor wants it or because it is geographically close. This can have the effect of sterilising an area. In the past, this has sometimes been the case in Australasia where Australian sub-franchisors commonly asked for the rights to New Zealand to be included and often succeed in obtaining them. However, New Zealand is a long way from Australia. It is a different market and it was neglected. There are other areas where a similar approach is adopted by some would be sub-franchisors of which a classic example is the whole of the Middle East.

**3. Exclusivity** Most sub-franchisors expect to have exclusive rights to the agreed territory. This enables them to invest with the comfort of knowing that they are investing in a market in which they will be the sole exploiters of the opportunity. Exclusivity is normally tied to performance criteria and can be lost if these criteria are not met. This can lead to practical problems if one has a network which is being developed by a sub-franchisor who fails after a period of time to meet the performance schedules.

The consequences of such failure need to be carefully thought through since they will have a critical effect on the future of the network in that territory. Many sub-franchisors

would consider the franchisor to be behaving extremely unfairly if the whole contract were to be terminated. Many might say that loss of exclusive rights merely because there is perhaps a temporary hiccup, which can be attributed to economic circumstances or unavailability of suitable premises, is a harsh and unjust outcome for a sub-franchisor which is otherwise performing its obligations.

Terms can sometimes be negotiated to provide for a sub-franchisor, who expresses these concerns, to make payments to the franchisor to compensate it for the loss of revenue by the non-achievement of the performance schedule in cases where the sub-franchisor wishes to preserve his position. This method is only a temporary expedient and does not necessarily compensate the franchisor for the fact that there has been a loss of impetus, unless, of course, it can be recovered later.

In practical terms, the mere loss of exclusivity without the loss of the continuing right to grant further sub-franchises could result in parallel networks being operated - one by the sub-franchisor, and the other by the franchisor or by another sub-franchisor (recruited by the franchisor to replace the one in default). This is also the practical effect which occurs when the sub-franchisor not only loses exclusivity, but also the continuing right to grant sub-franchises. The presence of two sub-franchisors in a market will also create other difficulties:

- the two networks may result in two different sets of standards. Indeed the first sub-franchisor whose rights have been restricted may not be so sensitive to the need to keep standards high
- if a sub-franchisee of the first sub-franchisor is to move premises for reasons beyond its control it may need to encroach on the catchment area or territory of a sub-franchisee of the new sub-franchisor
- it may be difficult to achieve co-operation between the two sub-franchisors in advertising and marketing activities
- the prospective sub-franchisees of the new sub-franchisor

may be more difficult to recruit since they will know that the first sub-franchisor was terminated and its sub-franchisees may well deter such prospective sub-franchisees.

The likelihood of one or all of these problems arising means that careful consideration has to be given to the issues. In many cases franchisors favour the clean break and so invariably would the new sub-franchisor. Indeed the continual presence of the first sub-franchisor could well inhibit interest from other prospective sub-franchisors.

**4. Performance schedule** The agreement of a performance schedule which sets out the projected annual and cumulative rates of growth of the network in the targeted territory is a common feature of these agreements. Indeed, without it, the franchisor would not have the confidence that a commitment exists which can result in the proper exploitation of the territory. Unless a sub-franchisor is prepared to accept a realistic performance schedule for the establishment of operational units, the master franchise route can lose some of its attractions. Where exclusive rights are granted the performance schedule is obviously of great importance because this is the franchisor's insurance policy against under-exploitation.

There are practical difficulties in establishing performance schedules. It may not be possible at the time the contract is being negotiated to have an accurate idea, or sufficiently accurate knowledge, to enable the parties to judge what would be an achievable rate of expansion. One thing that is certain is that the franchisor's requirements are likely to be very bullish, while the sub-franchisor's expectations will tend to be more modest. However, most sub-franchisors will prepare business plans in the process of deciding whether or not to take the opportunity on board and these must include some assessment of the growth rate which the business is capable of achieving. Without this, the sub-franchisor would not be able to make a balanced business judgement about whether or not to go into the proposition, and the level of resources which would need to be committed to it.

Furthermore, one has to consider the transition from the way in which the business is conducted in its country of origin to what is required in the target territory. A number of differences may have to be recognised, considered and resolved before one can be certain that the concept actually works and has been "fine tuned" so that it meets the requirements of the market place in the target territory. The variations required may be slight; they may be subtle; they may be fundamental, but whatever the category they can have a sufficiently significant effect on operations to make the difference between success and failure.

To identify what is required usually requires the establishment of one or more operations (pilot operations) to achieve the necessary degree of knowledge and to demonstrate to would-be sub-franchisees in the target county that there indeed is a business which has been proved successful in the market place. The experience so obtained of the marketplace can determine whether the development schedule which has been agreed will be effective, or whether it is in need of change by mutual agreement to reflect the reality which has become apparent. Indeed, the sub-franchisor may conclude that it does not wish to continue in the light of the results obtained in the marketplace from the operation of the pilot units. The master franchise agreement has to be sufficiently flexible to accommodate the practical realisation of the parties' expectations. There is the issue of who establishes finances and takes the risk of involvement in the pilot operations. There are some alternatives which are discussed in Chapter 3.

So far as the piloting is concerned, the franchisor must be sufficiently receptive to other ideas and to face up to the need to recognise that there are differences. They are likely to be people related; attitudes will be different; social and cultural attitudes may have an effect. The ultimate outcome may not result in the franchisor compromising the way in which the basic business is operated. The changes may have to be made in marketing methods, staff recruitment, training, management and accounting, and procedural methods.

There may be different business flows during the course of the opening hours. This could result in the outlet being busy in the target territory at different times of day from those which are most popular in the original territory. This may mean that not enough business is generated overall to make the business in the current form a viable proposition. This will require experimentation in order to resolve the problems and gear-up the business to be successful in the target territory.

All franchisors will use the existing operating manual as their starting point. How much change will be necessary will depend upon the nature, range and scope which the manual covers. If, for example, it deals in detail with the hiring and firing of staff with an explanation of the legal issues and procedures this will need to be changed for use in the target territory.

After the initial shock to the franchisor and its system has been overcome, it will be necessary for both franchisor and sub-franchisor to liaise in regard to the future development of the system in the target country. The franchisor's development of its system in the country will have to be shared with the sub-franchisor; the sub-franchisor's response and input must be considered and appropriate changes introduced.

The franchisor will always wish to retain control over whatever changes are made to the manuals and system in the target territory. The franchisor will also require that the ownership of the manuals and the system are retained by it.

The provisions in the contract have to be drafted to allow sufficient flexibility to:

- leave the franchisor with control, but
- provide for the co-operation which will be necessitated by the requirement to allow the business to develop as the years pass.

Part of this aspect of the matter will include developing the operational franchise agreement into which the sub-franchisor will enter with sub-franchisees.

Normally, the franchisor will start with the form it uses in its domestic operations and try to keep to it as far as possible.

This is often not possible since legal systems differ as does the terminology and the approach adopted to certain issues, e.g. corporate law, real estate law.

The important issue for many franchisors is to ensure that contractual requirements can, in substance, be enforced in the target territory. The franchisor will always want to have the ultimate control over the form and text of the operational agreements which are so crucial in protecting its name, reputation, trade marks, service marks, know-how and systems. The franchisor will also wish to have confidence in the operational agreements it may inherit on termination. Agreement will have to be reached about how much continuing support will be provided by the franchisor and whether this is included in the fees payable or will have to be paid for separately.

How the parties initially come into contact with each other will also have a bearing on the negotiations as there are many instances in which the prospective sub-franchisor, having seen a business in another country, makes a judgement that the concept will undoubtedly succeed in his own country and subsequently approaches the franchisor for the master franchise rights. Such enthusiasm by the prospective sub-franchisor should not lead to the franchisor accepting him without question. Great care has to be taken in selecting sub-franchisors. It must be understood that they are not expected to open only one operational unit but fully to develop the market and to adopt the role of franchisor in the target country. For a franchisor venturing abroad for the first time this means that it is looking for a different calibre of franchisee from those with whom it has so far dealt. For those who do not franchise in their own country for whom the selection of a franchisee is a novel experience there may in reality be no difference since neither types of franchisor will have had relevant experience. The greatest caution must be exercised since the cost of making a mistake could be extremely significant. The decision must not be rushed and however impatient the franchisor may be to get on with it, it must always, right up to the point of agreeing everything, be capable of withdrawing unless it is absolutely certain that the

sub-franchisor has the necessary qualities and resources

**5. Franchise Fees** (See Chapter 6)

**6. Withholding tax and grossing-up provision** (See Chapter 6)

**7. Training** Training of a sub-franchisor should go beyond training in the running of an operational unit. The sub-franchisor needs training and assistance in how to be a franchisor. To do this one needs to examine the range of services which the sub-franchisor needs to provide and to educate the sub-franchisor in those areas. This is important to the arrangement for without them the sub-franchisor would not be able to maximise the benefits to be obtained from the franchisor's experience. The areas in which the sub-franchisor will need assistance will include:-

- Site assessment, evaluation and choice. The franchisor will not have the detailed knowledge in the target territory of premises and the market, which is possessed by the sub-franchisor, but it will know the type and size of premises required for the concept's equipment and furnishings. There may also be some common criteria for the evaluation of sites which may emerge.
- Use of plans and specifications and the way in which they have to be adapted for use in the territory so as to ensure that they comply with construction laws and building codes and accommodate the franchised business.
- Providing the sub-franchisor with operational assistance:
  - in developing the pilot operation on the commencement of the business, and
  - on an on-going basis to help monitor performance and offer advice.
- The preparation of criteria for the selection of sub-franchisees. The franchisor cannot expect to be involved in the recruitment and selection of sub-franchisees, but it may have some valuable guidance to offer to the sub-franchisor on selection methods. It may assist in the selection of some of the early recruits to the network.

- The selection and approval of suppliers may be an important feature of the franchise. The franchisor will need to help the sub-franchisor identify suppliers and the criteria to be applied in their selection. If the franchisor has products which are to be sold by sub-franchisees and which are fundamental or products for which a proprietary specification exists or if there are secret formulae (eg recipes in fast food) the franchisor may, if it cannot supply at reasonable prices from its country, have to grant rights to manufacturers to produce the products to the franchisor's specifications in the target country to enable the franchisor's trade mark to be affixed. Indeed many franchisors seek to achieve local suppliers of products.
- The provision of marketing, promotional and advertising materials used in the territory of origin which may be useful in the target territory.
- Access to the on-going research and development which the franchisor may be conducting.
- The ability to participate in franchisee seminars and franchisee get togethers organised by the franchisor.

The degree of formal training support will, of course, vary from case to case. However, many franchisors find it sensible, particularly in the early stages, to ensure that both the sub-franchisor's staff, and the sub-franchisees and their staff, are trained at the franchisor's domestic training facility. There are many who find that the quality of training at the domestic base just cannot be reproduced and, even though there have to be changes made to accommodate local requirements, this degree of training is essential. It provides an in-depth orientation coupled with visits to operating units which cannot be provided elsewhere

One would expect that the contract would contain the details of how, and how many of, the sub-franchisor's team will be trained.

In appropriate cases, the franchisor may provide an opening crew for the first few units which are established in the target territory. This crew will provide on-site training for the sub-



franchisor's staff. Normally, the cost of training is included in the front end fee but there are also those who charge separately for such training. The sub-franchisor and his sub-franchisees would in any event be expected to pay all their expenses relating to getting to and from the training location, their subsistence and other expenses which may be incurred during the provision of the training.

The intensity of training and support which is given during the piloting stage in the target country can be quite high depending on how complex and extensive are the operational requirements. The agreement may provide for the subfranchisor to establish its own training facilities in the course of time, and for the franchisor to provide the necessary back-up and training aids to enable this to be done.

#### **8. Advertising** (see Chapter 6)

**9. Trade marks and other intellectual property rights** (see also paragraph 5 in Chapter 2) The trade marks, service marks, trade name, goodwill, copyright, know-how, confidential information, and other industrial and intellectual property rights will always belong to the franchisor.

The sub-franchisor may have to prepare translations of the operational manuals and other written material, when care should be taken by the franchisor to ensure that the copyright in such translations will belong to him.

The contractual provisions will have to deal with the licensing of these property rights in accordance with the legal requirements of the target country. The sub-franchisor would be expected to control and police the use of these rights by sub-franchisees and to report to the franchisor any infringements which may take place of which it becomes aware. The franchisor would naturally accept responsibility for taking relative legal action at its own expense as may be necessary to protect and preserve its intellectual property.

**10. Sale of the sub-franchisor's business** The master franchise agreement will contain provisions dealing with the basis upon which the agreement may be assigned and the sub-fran-

chisor's business sold.

The basic principles are the same as those which apply to the sale of a franchised business by a sub-franchisee. No franchisor would want to admit to its network a franchisee who did not meet its selection criteria. The same principle applies in the case of a sub-franchisor. However, there are differences because the level of investment will inevitably be much greater, and the skills which the purchaser will require will not be the same as those which are required for the operation of a franchised unit.

A purchaser of a sub-franchisor's business will not only have to demonstrate his financial capacity, but also his ability to understand the franchise system and to manage the business of a sub-franchisor. The basic criteria which will be applied should be specified as should any conditions which are considered appropriate. The prospective sub-franchisor to be accepted should at the least match the franchisor's selection requirements for sub-franchisors.

One should bear in mind the possibility that an interested purchaser could be a competitor. The purchaser might also be a large company, which is wishing to expand and diversify its business. In these circumstances, special considerations may have to be given as to how the franchisor's know-how and confidential information can be confined to the franchised business, and not made available elsewhere within the purchaser's organisation, or group of companies. Another factor which may need to be considered is that the sub-franchisor's business could become significantly large and it may wish to have the ability to have its shares dealt in in a recognised stock exchange. If the sub-franchisor's financing is provided by venture funds or other financial institutions they may require this option as an "exit route" for their investments.

It is often provided in master franchise agreements that the sub-franchisor must appoint a managing director, chief executive officer or general manager of its business whom the franchisor must approve and train. It is also sometimes provided that such person should have a minimum equity stake in the

business. If business changes hands this requirement will understandably continue and provision should be made in the agreement that such appointment, subject to approval and training, will be made by the purchaser of the sub-franchisor's business.

**11. Protection against misuse of know-how and unfair competition** Most countries permit in-term prohibitions against competition and post-term prohibitions, provided, in the latter case, that the length of time and the area of operation of the restraint are reasonable. Clearly, an investigation has to be made in each territory to ascertain what are the rules, and in this respect, one also has to have regard to competition laws which increasingly affect these covenants. There are some countries which either do not permit such restraints or which apply narrower principles to their application than is common elsewhere.

It is also relevant to consider the know-how relating to the systems, methods, etc., which the franchisor is also entitled to protect. Normally, one could expect a greater degree of protection to be available at law in respect of know-how than would be permitted where non-competition provisions are concerned.

Effective control on the use of know-how can complement a franchisor's protection against unfair advantage being taken by franchisees of what they have learned from a franchisor. One must however always be aware of the difficulties in enforcing clauses aimed at protecting know-how. It is often difficult to establish that the know-how is sufficiently secret and confidential to be capable of protection. Copyright as a method of such protection is not entirely satisfactory because it does not protect the substance of the information, only the way in which it is expressed.

In the EU, the competition (anti-trust) laws have been held by the European Court of Justice to apply to franchising. Exemption is however available for certain categories of franchise agreements (which in practice means most), provided that they comply with the terms of a regulation which (among other things) establishes the basis and parameters for the protection of know-how, and in-term and post-term restrictions on

competition. This regulation has to be taken into account within EU member states. There are also anti-trust laws in the member states of the EU which have national rather than pan-european effect. These can also affect the scope and extent of the protection available.

**12. Default issues** One of the difficulties for a franchisor in master franchise arrangements is that it is no longer in a position to exercise day-to-day control of the operations of the franchised units. It is therefore crucial to the franchisor that the sub-franchisor monitors and controls the quality and standards which are achieved by its sub-franchisees. It is appreciated that the sub-franchisees are trading, using the franchisor's know-how and systems, and are benefiting from the goodwill associated with the name.

The franchisor runs the risk of events occurring which are adverse to its interests and it may not learn that there is a problem until it has become a big problem. The sub-franchisor as the custodian of those interests in his territory has to recognise its responsibility. Provision should be made in the agreement for the policing of those standards by the sub-franchisor, but if it fails to do so, the franchisor has to have remedies. These would obviously be built into the default provisions in the contract.

One often finds attempts are made to introduce into contracts wording formulae, using expressions, such as 'material or substantial defaults', but these are often so difficult to interpret. In the absence of any proper explanation of what the expression means, what a franchisor regards as 'material or substantial' a sub-franchisor may regard as not being so 'material or substantial', and how a court would determine the dispute could be open to question. What is certain is that a franchisor who believes that the correct standards are not being observed needs to have access to rapid remedies and not to be locked into a lengthy lawsuit while a Judge decides whether he thinks the default sufficiently serious.

It is advisable if one is minded to use an expression, such as 'material default', to have a precise definition which may, for

example, describe it as "any default under the agreement of which the franchisor has given notice to the sub-franchisor to cure and which remains uncured after a fixed period of time", which depending on its nature may be as much as 30 or 60 days.

Money defaults will usually be treated more seriously by franchisors with a shorter period of notice. Quality control defaults may need a longer period in order for the default to be put right because it may involve enforcing rights against sub-franchisees.

The failure by the sub-franchisor to ensure that its sub-franchisees comply with the terms of their contracts is a serious issue, but one which may require reasonable time to cure. The problems may also not best be solved by requiring the sub-franchisor to undertake legal proceedings. The solution of operational problems leading to a lowering of standards can often be dealt with by direct discussion and persuasion, rather than by resorting to law. The parties must acknowledge that there are a wide range of methods available to cope with these problems. Ultimately, of course, the franchisor must be able to bring matters to a head to protect its interests. The franchisor may well be influenced by what course of action it wishes to have available by what the sub-franchisor did or failed to do which caused or allowed the breach complained of to occur.

There will, as in most commercial agreements, be provision for termination in the event of insolvency, bankruptcy, or liquidation.

Consideration must be given to whether the sub-franchisor is to have the right to terminate the agreement, and in what circumstances. In some cases, the sub-franchisor is given the right to terminate in the event of the insolvency, bankruptcy, or liquidation of the franchisor. It is comparatively rare to find that the sub-franchisor has a contractual right to terminate.

**13. Post-Termination consequences** The consequences of termination are usually drastic. In brief terms, one would expect that the sub-franchisor will lose the right to continue to offer or operate the franchise; will have to de-identify his business; and be bound by effective post-term restraints on compe-

tition and the use of the franchisor's know-how.

There are other considerations and one of the most important is, of course, what is to happen to the network of sub-franchisees?

- Will the franchisor be entitled to take them over?
- Will the franchisor be obliged to take them over?
- Will the sub-franchisor be able to make a virtue out of termination and claim payment of a sum of money by way of "compensation" for "the takeover of its business"?
- Will the franchisor, now that it has terminated the sub-franchisor for good cause, want to take over what could be a badly-run network of disgruntled sub-franchisees, who are intent on making difficulties, and be faced with considerable expense to put the business right? Rather than the sub-franchisor expecting to be paid something (as mentioned above) should it, on the contrary, be liable to pay the franchisor for the costs the latter will have to face in coping with the problems which it will inherit?
- What is to happen to any real estate (including freeholds and/or leases), which the sub-franchisor has acquired for leasing or subleasing to the sub-franchisees, and which may have a capital value which the franchisor cannot afford to pay?

The issue of whether the master franchise agreement should terminate as a whole if the development schedule is not maintained has been touched upon earlier.

What should be the consequences for the sub-franchisor and its network if it has a contractual right to terminate which it exercises? Should the sub-franchisor be entitled to continue as before, using to the full the franchisor's intellectual property rights, including the name and know-how, and, if so, on what basis? Is it right that the sub-franchisor may have to run the risk of losing its business when the franchisor is at fault, whether the fault arises voluntarily or involuntarily? Given the obligations of the franchisor in the particular agreement should the failure by the franchisor to perform any or all of them be fatal to the

agreement, given the continuing ability of the sub-franchisor to use the intellectual property and other rights?

The issues are many and varied, and the list provided is far from complete, but it will serve to indicate the complexity of this particular subject and the substantive issues with which the parties are confronted when negotiating. The ultimate problem is that no one can say that any particular outcome is the right solution. The right solution in any negotiation is what the parties agree to after their negotiations hopefully having fully considered the potential impact of what they have agreed.

**14. Choice of law and forum** All contracts really should specify the law to be applied to the contract, and the venue for the resolution of disputes. Consideration should also be given to whether the parties wish to have disputes referred, or capable of being referred, to arbitration. The recent development of alternative dispute resolution which is a form of mediation may also be considered.

The choice of law is a difficult decision and affected by many considerations. There is a spectrum ranging from countries which respect the contracting parties' choice of law to those which will not enforce a foreign law contract against their own nationals. Franchising arrangements involve some legal requirements which cannot be contracted out of.

- In most countries the courts will not enforce "public policy issues" provisions in contracts in accordance with foreign laws. Restrictive covenants, competition law, and exchange controls are the type of provisions which fall into this category.
- The treatment of intellectual property rights, which the sub-franchisee is licensed to use, will fall to be dealt with under the law of the country in which the business operates. The laws of State A where the franchisor is based relating to trade marks would not affect the treatment of trade marks in State B where the sub-franchisee is carrying on business. There are also other laws which are statutory creations in the country in which the business is conducted which cannot be

avoided.

Another factor is that the sub-franchise agreements would undoubtedly be subject to the law of the country in which the sub-franchisee is operating. There may well be legal difficulties in having the master franchise agreement (out of which all sub-franchise rights are granted) governed by a different legal system from that which governs the contracts for the operational units.

The choice of forum will depend on a number of considerations not the least of which is whether the courts in the country of choice of law dispense justice fairly. There are countries in which judges are bribed and there are some in which foreign franchisors may find it difficult to win against local nationals. The choice of law does not commit the parties to use the courts of that country. The issue is whether the judgment obtained in whichever country provides the forum can be enforced effectively against the other party in the country in which it carries on business or has assets sufficient to discharge its liability.

The subject is too wide and too legally complex to be given fuller treatment in a work of this nature. It is necessary to obtain legal advice which will take into account the issues raised and the existence of treaties for the enforcement of arbitration awards and court judgements.



## CHAPTER SIX

# Financial Considerations

THE starting points for the consideration of the financial aspects of the master franchise agreement are:-

- What level of business and profitability will the franchised operational units be able to generate? In reality it is only out of the business which can be created at that level that all the parties involved can benefit.
- What is the value of the franchisor's trade mark and/or trade name and what value does it add at the operational level as well as in assisting the sub-franchisor to sell sub-franchises?
- What is the value of the franchisor's system embracing its secret and confidential know-how and information?
- What will it cost to
  - establish the franchisor's name in the target country so that it is as valuable there as it is in its domestic market?
  - develop the franchisor's system so that it is fully effective and operative in the target country?

The sources of income to which a franchisor can look in the operation of a domestic network usually include one or more of the following:-

- an initial fee
- a mark-up on product sales
- a continuing franchise fee (also rightly or wrongly called a royalty)

There may be other opportunities for a franchisor to secure an income flow

- by becoming involved in the real estate chain and deriving a

"profit" rent, i.e. it receives more than it pays out

- by receiving payments of commissions or overrides including retrospective rebates from suppliers to the franchise network
- by leasing equipment to franchisees.

Whatever sources of income or combinations are the chosen method they will provide the financial pool which will have to be enough to make the transaction worthwhile for franchisor and sub-franchisor under the master franchise agreement.

Let us examine therefore what the franchisor is likely to expect out of the agreement. The most obvious is that it wants a sufficiently attractive result to make it worthwhile to do the deal. However the income flow from the operating units will not increase just because there is a master franchise agreement. The franchisor cannot expect the sub-franchisor to be able to pay over so much that it is not in a position to run its own business profitably. The franchisor will invariably expect to be paid

- an initial fee and
- continuing fees or royalties (which includes possibly some of the other methods of payment referred to above).

There is no answer to the question of what these fees should be. Very often one suspects that there is little science applied to these calculations and that they result from "horse trading". The problem is that if the fees are set at the wrong levels it is likely adversely to affect the growth and development of the sub-franchisor's network. Every pound the sub-franchisor pays in an initial fee is a pound less for network development. Every pound paid in continuing fees or royalties is a pound less for network services and profitability. It is important that the right balance is struck and that both parties recognise that they should be looking for a steady medium to long term growth rather than a short term "killing".

There are, one would suggest, some general principles which need to be considered when seeking to establish what the fees should be.

## **Initial Fees**

As will be appreciated it is not easy agreeing what the franchisor should receive for

- the grant of the rights,
- the transfer of know-how, and
- assisting in setting up the sub-franchisor in the target country.

If this was easy it would not cause the problems with which one is so often confronted. Indeed, there are many franchisors whose expectations are such that any would-be sub-franchisors are frightened off. The author is aware of a significant number of such cases. There are also instances in which unrealistic figures have been agreed only to be resented by the sub-franchisor when it realises that it cannot make money at all, or, at least, sufficiently quickly to justify the high level of the initial cost.

It seems that there are a number of factors which should be taken into account when trying to calculate what would be a proper level of initial fee to be paid to a franchisor. The degree of importance to be attached to each will differ from country to country, depending upon the practices to be found in each and their relative impact on the parties in their discussions. The factors are:

- The actual cost to the franchisor of dealing with the sub-franchisor having assisted it in setting up its business and helping to prove the concept works within the target country.
- How much would it cost, and how long it would take the sub-franchisor to acquire the requisite know-how and skills to operate a similar business in its country assuming it set it up by itself. If this can be done as quickly and for less or at not much more cost, the prospective sub-franchisor may question whether it needs the franchisor.
- The value of the territory as estimated by the franchisor. Many franchisors tend to have their ideas about what the territory is worth coloured by their experience in their own country.

In their country their name is known, their system is well established (if it is not they should not be venturing abroad) and franchisees will merely accept the value and cost of entry but may also be prepared to pay a premium for entry. When moving to another country the franchisor is often offended to be told - "we have never heard of your brand - how do you know that your system and networks will work here?" The result is that from perhaps being tracked down by eager franchisees in their domestic sellers' market they find that they are in a buyers' market and are faced with unfamiliar attitudes. The franchisor has to accept that under a master franchise agreement it will be for someone else to have an act of faith and to establish the franchisor's name, reputation and system in its country. A patronising "we are the greatest - we don't understand your reservations" has no place in such a scenario. The franchisor has to be mindful of the problem and sensitive to the views and reservations of those with whom it will be negotiating.

- The estimated aggregate amount of the initial franchise fees which could be charged by the sub-franchisor to its sub-franchisees in the development of the network in its country. To explain this, let us assume a country where there is a potential to charge by way of initial fees (excluding goods or services which may be provided initially) of £5000. The country has the potential to accommodate 100 outlets of the franchised business. This provides an aggregate potential initial fee income of £500,000 ignoring the fact that the franchisor may be able to increase the fee gradually as the network grows and membership of it is more highly sought after. One has to take into account the fact that to earn these initial fees the franchisor will be incurring expenses. One cannot assume that the country rights are worth £500,000. A lump sum payment would in any event have to be discounted to take into account the cost of earning it as well as the time it will take for the market to be fully exploited.

- The value which accrues from the franchisor having developed and run its system in its own and perhaps other countries

with success. Experience of opening in other countries should provide a franchisor with the realism which flows from experience. Whatever lessons may be learned from establishing the pilot operation in the target country will be based on what has already been learned and may reflect lessons already learned in the course of the franchisor's previous experience of international development. This enables the parties to have a starting point which may or may not require adjustment - it may then only be a question of degree rather than a fundamental issue.

Franchisors who are based in those countries where high initial fees are charged to franchisees tend to have much higher expectations and therefore, tend to demand far more than may be considered realistic in the target country. As the medium-to long-term interests of the franchisor probably are best served by having a well motivated and successful sub-franchisor, a franchisor with this attitude will need to recognise that its attitude is counter-productive and has to be reconsidered.

Whatever considerations (including horse trading) are used to finalise the negotiations and reach agreement on the amount there are methods of structuring payments which may spread payments over a period of time or be related to opening of operating units.

The way in which whatever is agreed as being an initial fee is structured will be affected by other considerations including taxation and exchange or other financial controls which apply in the target country. For example the tax treatment of initial fees in some countries (even where a double taxation treaty exists if there is an applicable treaty) may result in them being regarded as advance royalty payments and subject to withholding tax. Exchange and other financial controls in the target country may require registration with and approval by a finance ministry or other governmental body. This may result in a challenge to the level of the initial as well as continuing fees. Despite the fact that the initial fee may be related to the provision of initial services in the form of training or support services the authorities may still treat the payment as a royalty.

**Continuing fees or royalties** are normally calculated as a percentage of the aggregate amount of the gross network sales to the ultimate consumers in the target country. The level at which they are fixed obviously has to provide the franchisor with a good economic reason to be involved, but it must be appreciated that in a master franchise agreement these payments represent a straight deduction from the gross income of the sub-franchisor, and that if they are too high, the sub-franchisor will not be able to run its business profitably. In such circumstances, the network of sub-franchisees will not be given the proper support and cannot succeed.

In the case of direct franchising either on a unit by unit basis or under the framework of a development agreement the franchisor will no doubt expect to be paid the same continuing fees as it charges in its domestic market; the issue may be whether it will be providing the same range of support and other services to the foreign franchisee as it provides to its franchisees in its domestic market. The issue may go even deeper into whether the franchisor has the resources to provide the same range of support and other services in the target country.

One often sees an initial presentation to prospective sub-franchisors by franchisors (who operate their domestic operation on, say, a five or six per cent of gross sales paid by fee their unit operators) in which they ask for a fee equal to three or four per cent of gross network sales from the sub-franchisor. That sub-franchisor in market terms may not be able to charge more than five or six per cent to its sub-franchisees. Indeed, if it were to be receiving an income based on that sort of percentage, and there was no involvement by the franchisor, it would be able to run a very viable and profitable business. However it is doomed to failure if it loses what would be 60 to 80 per cent of its gross income to the franchisor which is what the effect would be of the franchisor's demands. In many cases it is difficult to succeed as a sub-franchisor if the franchisor's continuing fee represents more than 10% to 20% of the income the sub-franchisor generates from its sub-franchisees. It should be borne in mind that whatever is paid to the franchisor is a first call on the sub-

franchisor's income. How many businesses can operate sufficiently profitably to make the business proposition worthwhile when they lose more than 20% of their gross revenue?

The financial effect on the sub-franchisor's business of establishing the level of continuing fees has to be thought through very carefully. Proper financial projections and a business plan must be prepared to demonstrate the effect which the level of fees payable by the sub-franchisor will have on the viability of its business. There are sometimes different approaches to fees; for example variable levels according to turnover; fixed fees; minimum fees. These are very much an exception.

There are those franchise systems in which the franchisor is the manufacturer of products or a supplier of products made to its specification by licensed manufacturers. There are some cases where the sub-franchisor is licensed to manufacture the franchisor's products and to supply its network of sub-franchisees. Some franchisors enter into licensing agreements with local manufacturers in the target country for the supply of products to the sub-franchisor and the sub-franchisees within the network. In each of these cases the franchisor and sub-franchisor would participate in the mark-up on the products. This may be the sole income of each of them (although this is more rare) or it may be part of their income together with one of the other methods of charging continuing fees or royalties.

The method of making payments also has to be carefully related to the way in which the sub-franchisor will be dealing with sub-franchisees. For example, if sub-franchisees pay their fees monthly by the 10th day of the month, an obligation on the sub-franchisor to make payments to the franchisor monthly on the 10th day of the month would not be capable of being performed. Yet one sees provisions of that nature. The payment periods and accounting periods at both levels have to tie in with each other so that the sub-franchisor has the opportunity to collect fees from sub-franchisees, check them against reported revenues and prepare and submit reports and payments to the franchisor. Where product supply is a feature the terms and conditions of supply and payment will have to be dealt with

separately in the agreement.

Another question to be considered is whether the sub-franchisor is to be responsible for paying franchise fees to the franchisor whether or not the sub-franchisor has been paid by its sub-franchisees. This will be a subject for negotiation. It is unlikely that the franchisor will wish to act as banker to the sub-franchisor and accept its credit risk. So far as products are concerned the sub-franchisor will have to be prepared to fund purchases from the franchisor or other supplier and ensure that sub-franchisees pay promptly so that sub-franchisor's exposure to risk is kept as low as possible.

There should always be a provision in the master franchise agreement requiring the sub-franchisor to ensure that sub-franchisees observe and perform the terms of the sub-franchise agreements. This would inevitably mean that a failure by the sub-franchisor to collect fees and financial reports would be a breach of contract. In practical terms, a defaulting and non-paying sub-franchisee will not only not be paying fees, but will also probably not be submitting returns of gross sales, which, of course, will mean that no-one will know what should be remitted. There are techniques for coping with this sort of problem.

The franchisor will invariably stipulate the currency in which it wishes payment to be made. In most cases, the franchisor would like payment to be in its own currency. This requires the establishment in the agreement of a conversion date. It is also sensible to identify which bank's quoted rate will be used on that conversion date, so that there is an accurate method for the parties to ensure that the right amount of currency has been remitted. Provision will usually be made for the cost of remittance and conversion to be borne by the sub-franchisor.

There may be exchange control requirements to be complied with in some countries. The mere fact that exchange control permission has been obtained does not necessarily mean that payments will be made with any degree of regularity because payments can be delayed administratively by the country's central bank when it assesses the anticipated total outflow of funds



from the country during any particular month compared with the available resources. Furthermore the banking system combined with the local bureaucracy may well cause further delays in payment. These possibilities need to be considered where appropriate and dealt with in the agreement.

A franchisor might consider the establishment of a bank account in the target country to ensure the quick flow and availability of funds as the bankers do not always move funds as rapidly as the needs of the parties require. Very specific provisions have to be written into the agreement to avoid any payment problems which can be anticipated.

If by reason of exchange controls, currency conversion cannot take place, provision should be made in the agreement to establish what will be the alternative.

Bearing in mind the long-term nature of these contracts, often one has to insert provisions to allow for the possible introduction of exchange controls as the mere fact that a country has no controls at the time the contract is negotiated does not mean that at some time during the life of the contract, that such controls will not be introduced, albeit temporarily.

**Withholding of taxes, and gross-up provisions.** In dealing with the payment provisions in the contract, the way in which payments will be treated and characterised for the purposes in both the franchisor's country and the target country should be considered.

Any double taxation agreement which exists should also be examined to ensure that if the franchisor wishes to receive payments which are free of withholding tax, this can be done so far as possible. Provision should be made in the contract to enable the franchisor to obtain the benefit in its own country of any double taxation agreement by the provision of evidence of payment in the target country in such form as may be necessary to enable the relief to be claimed. This avoids paying tax twice on the same amount.

Some franchisors insert what are called gross-up provisions in their contracts, which provide that if tax is deductible, effectively it has to be borne by the sub-franchisor increasing its pay-

ment to the franchisor so that the franchisor receives the same amount net as he would have received had there been no deduction. The effect of such a provision is to increase the level of fees payable by the sub-franchisor as it is effectively paying the franchisor's tax liability on the payments which are remitted to it. This would be a cost which would not be recoverable from the franchise network, and if a sub-franchisor is forced into accepting such a provision, then the sub-franchisor should check its projections and cash-flow forecasts to ensure that this additional burden does not make the proposition unacceptable.

### **Advertising**

Most franchise systems provide for advertising to be organised by its franchisor financed by contributions made by franchisees of the operational units. There are three basic alternative arrangements which are found in domestic arrangements.

1. The franchisor charges the franchisee a sum calculated as a percentage of the franchisee's gross income rather in the same way as the continuing franchise fee (management services fee) is calculated. The sums received by the franchisor from the franchisees are spent by the franchisor on advertising and promotion. Most franchisors will want to have complete control over the nature and extent of the advertising and promotional activities upon which the sums recovered are spent.
2. The franchisor includes the advertising expense within the continuing franchise fee and undertakes to spend not less than a minimum percentage of such fee on advertising and promotion. Again, most franchisors will wish to have the same degree of control over advertising and promotional activities.
3. The franchisor undertakes to do such advertising and promotion to such extent as he thinks fit without collecting a contribution or allocating a fixed sum for the purpose. This approach is often adopted where the franchisor is a manufacturer which is already a substantial advertiser on

its own account and the franchisee will inevitably benefit.

There are some cases where advertising concentrated more in the area in which the franchisee is operating is more appropriate and effective than national advertising. This often results in authorised local advertising with the franchisee obliged to spend a fixed percentage of its gross revenues on such advertising activities. The franchisee may also be required to make some small contribution to a limited amount of national advertising.

In some countries, notably the USA, regional advertising with franchisee participation in regional advertising committees is to be found.

Many franchisors expect their sub-franchisors to follow the same advertising procedure in the target country as operates in their own country.

There are some systems where international advertising may be particularly appropriate. This approach, for example, is essential if there is a system which is transnational such as car rentals and hotels where an international directory is a common feature of the international marketing of the system.

The advertising arrangements need to recognise the marketplace and the best ways in which to exploit it. While use may be made of materials prepared in the franchisor's domestic market the sub-franchisor may take care to ensure that the franchisor is not spending advertising contributions from the target country's resources without producing material which is usable and which saves at least as much as it costs and which does not need a significant amount of money spent on it to prepare it for the local market.

The franchisor and sub-franchisor should ideally be able to work closely with each other in relation to advertising in the target country. After all, the local knowledge of the sub-franchisor is an important element in the relationship - the franchisor cannot expect to know more about the sub-franchisor's market than its sub-franchisor.

## CHAPTER SEVEN

# Franchise Regulation

IT could be said that there are two types of Franchise Regulation.

- regulation which is specifically focussed on franchising because it is franchising
- regulation which affects franchising because of its applicability to one or some of the elements of a franchise system

There is not much regulation which is specifically focussed on franchising. In fact, there are only nine jurisdictions in which such laws are to be found. It was not until 1970 when the State of California in the USA enacted its Franchise Investment Law that such focussed laws existed. Since then in the USA some 14 other States and the Federal Trade Commission have added their contributions. For many years they were only joined by the Province of Alberta in Canada. However, in recent years Brazil, France, Indonesia, Korea, Mexico, Russia and Spain have joined this select club. It is understood that Malaysia is also considering the introduction of some form of legislation. In Italy there are now 2 bills in draft form which are being promoted by different groups in the Italian parliament.

Before commencing any negotiation for a franchise in any of these countries one should take advice even if the negotiations take place outside the country concerned to ensure that the local law is not infringed and the franchisee is unexpectedly able to exercise remedies for a failure to comply initially at requirements.

We shall briefly consider the position in each of these countries. The information provided is only a summary to give guidance of what is involved - proper advice should be obtained.

## **Australia**

Australia has been flirting with franchise regulation since 1985/86 when the Federal Government issued a Franchise Agreements Bill for comment. This step which was taken in response to a decision by a Judge that the sale of a franchise was the sale of a security and then subject to the Companies Codes. This resulted in the imposition of a disclosure requirement modelled on the rules applicable to companies. This was notwithstanding that another Judge had disagreed with the first Judge's opinion. The absence of an appeal to a higher court meant that the uncertainty continued.

The Franchise Agreements Bill was widely criticised by franchisors and franchisees and replaced by a redrafted Bill which was published. This was equally criticised and abandoned. The government then passed a regulation exempting franchise agreements from the Companies Codes.

There followed more pressure for regulation which resulted in the establishment of a voluntary code administered by a company established for the purpose and supported by the Government. This eventually collapsed unlike the political pressure to do something. It had been clear that the Trade Practices Act which was robustly applied by the Judges provided franchisees with adequate remedies. Indeed many judgments were given about which many observers had doubts.

However this was not enough and the government recently introduced two proposed changes to the Trade Practices Act. One of the changes proposes the introduction of a prohibition against unconscionable conduct by a franchisor. The other proposes that Codes of Conduct should have the force of law. The proposals have received widespread criticism not only from the franchise community but also from independent organisations (eg. The Law Council of Australia).

So far as unconscionable conduct is concerned the proposals contain a prohibition against such conduct. In determining whether a company has engaged in unconscionable conduct the Court may have regard to:

- (a) the relative strengths of the bargaining positions of the supplier and the business consumer; and
- (b) whether, as a result of conduct engaged in by the supplier, the business consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the supplier; and
- (c) whether the business consumer was able to understand any documents relating to the supply or possible supply of the goods or services; and
- (d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the business consumer or a person acting on behalf of the business consumer by the supplier or a person acting on behalf of the supplier in relation to the supply or possible supply of the goods or services; and
- (e) the amount for which, and the circumstances under which, the business consumer could have acquired identical or equivalent goods or services from a person other than the supplier; and
- (f) the extent to which the supplier's conduct towards the business consumer was consistent with the supplier's conduct in similar transactions between the supplier and other like business consumers; and
- (g) the requirements of any applicable industry code; and
- (h) the requirement of any other industry code, if the business consumer acted on the reasonable belief that the supplier would comply with that code; and
- (i) the extent to which the supplier unreasonably failed to disclose to the business consumer:
  - (i) any intended conduct of the supplier that might affect the interests of the business consumer; and
  - (ii) any risk to the business consumer arising from the supplier's intended conduct (being risks that the supplier should have foreseen would not be apparent to the business consumer); and

- (j) the extent to which the supplier was willing to negotiate the terms and conditions of any contract for supply of the goods or services with the business consumer; and
- (k) the extent to which the supplier and the business consumer acted in good faith.

The Court must not have regard to any circumstances that were not reasonably foreseeable at the time of the alleged contravention and although it may have regard to circumstance existing before the proposal becomes law but not to conduct engaged in before that date.

The draft code of conduct was sent for comment over the Easter 1998 holiday with an incredibly short consultation period. The criticisms were many and widespread since the draft appeared to have been prepared in a franchise "knowledge free vacuum". A further draft - slightly improved - was produced with even less time for consultation and with a prohibition on its publication. The final version of the code was published as we went to press. Fortunately the government has been responsive to many (but not all) the criticisms sufficient to enable the Franchise Council of Australia to be encouraged. Franchisors, who are domiciled or who are based outside Australia, who have only one master franchisee, or one franchisee are exempt from the code. Despite this those seeking to do business in Australia will need to weigh up their options with great care and may conclude that there are other markets to explore with fewer obstacles before taking the undoubted risks the Australian market appears to be creating.

### **Alberta, Canada**

The original law relating to franchising dates back to the early 1980s when a disclosure and registration regime was introduced. The regulatory body which administered the legislation was the Alberta Securities Commission Agency to whom a form of disclosure document had to be submitted for approval. On approval being given and the franchise registered the franchisor could then offer its franchises for sale in Alberta.

This law was amended in 1995 when the pre-contractual disclosure requirement was continued but the requirement for registration with the review by the Alberta Securities Agency Commission ceased.

The disclosure document must be received by the prospective franchisee at least 14 days before signing any agreement or paying any money. The document must:

- comply with the requirements of regulations which came into force on 1 November 1995 unless exempt
- contain copies of all proposed franchise agreements
- contain financial statements reports and other documents in accordance with the regulations

There are exemptions in both the statute and the regulations.

The law goes somewhat beyond disclosure and contains provisions

- imposing on both parties a duty of fair dealing in performance and enforcement
- a right for franchisees to associate with each other
- a right for the franchisee to claim damages for a misrepresentation in a disclosure document

The law also permits the Lieutenant General in Council to appoint one or more bodies to govern franchising and to provide fair dealing ensuring franchisors and franchisee with power to make regulations for their establishment.

## **Brazil**

The law introducing a pre-contract disclosure requirement was passed on 15 December 1994.

The law does not regulate the relationship between franchisor and franchisee which continues to be governed by Brazil's Civil and Commercial Codes.

The disclosure requirements are quite extensive and include:-

- the business background and information about the franchise



- financial information including balance sheets
- what the franchisee will be expected to do
- the status of the franchisor's trade marks
- agreements with suppliers
- list of franchisees
- details of pending litigation
- investment required

The contract will also be attached to the disclosure document which must be presented to the prospective franchisee at least 10 days prior to the signing of the franchise contract or even a preliminary contract.

Failure by a franchisor to comply provides the franchisee with a right to rescind the contract obtain a refund of fees and claim damages.

## **China**

By a circular dated November 14, 1997 the Ministry of Domestic Trade promulgated "Measures for Administration of Franchise Operations" (for trial implementation).

These measures were introduced in accordance with instructions of the leaders of the State Council "with a view to standardising franchise operations and promoting the development of chain stores" and apply to franchise operations within the territory of the Peoples Republic of China.

Authorisation of the use of the name to be given to the franchise enterprise and the amount of royalties to be paid for what is described as the use of the franchise right are to be governed by existing structures.

The measures are also concerned with protecting the lawful rights and interests of both the franchisor and the franchisee. The measures seek to introduce a level of balance by dealing with not only the franchisor but also the franchisee.

The definition of franchising is somewhat basic but given its stage of development is probably adequate. The measure is stated to be for "trial implementation" so one imagines that experience will bring improvements.

There is a basic principal in that franchising issues are to be conducted in adherence to the principles of "voluntariness, fairness, compensation, good faith and standardisation".

There are descriptions of:

- Direct franchises
- Sub-franchise (regional franchise) which seems to include multiple franchising as well as master franchising.

The measure lays down requirements to be met by both franchisors and franchisees as well establishing their respective fundamental rights and duties.

The basic requirements for the contents of franchise agreements are listed as well as the types of charges which a franchisor may make to the franchisees. These include:

- initial franchise fees
- royalties
- security deposits
- other charges for services provided by the franchisor to the franchisee

There is a requirement for a franchisor to make written disclosure to a prospective franchisee at least 10 days prior to the signing of a contract. The minimum information to be provided includes:

- the name and basic facts of the franchisor's company its business performance, business consistency of its franchise
- an investment budget for the franchise based on practice
- methods of collection of royalties and various charges
- terms and restrictions for supply of articles and goods.

Intellectual property rights are to be handled in accordance with other relevant provisions.

The measures also identify other bodies which are to be concerned in drafting policies, regulations and managing guiding planning and co-ordinating franchise operations as well as codes of conduct.

## **France**

The law focussed on licensing of trade marks subject to the licensee accepting exclusivity or quasi exclusivity and thus affecting franchising was adopted by the French parliament on 31 December 1989. The law is named Loi Doubin after the member of parliament who introduced it.

The basic law provides that prior to the execution of a contract there must be provided to the franchisee (licensee) "a document giving honest information permitting the other party to make an informed decision". The document, whose contents were to be specified in a regulation, are to include:-

- information on the franchisors business, its experience and how long established
- the market and its growth potential
- the term and renewal
- termination and conditions for the transfer of the business
- scope of exclusivity granted

The document has to be provided at least 20 days prior to the execution of the contract or the payment of any money.

The regulation followed (obviously urgency was not a consideration) on 6 April 1991 and provided that the document must contain the following information about the franchisor and its business:-

- the registered office, its legal form, the nature of its activities the identity of its management and its share capital
- its registration number on the Commercial Companies' Register or its registered number on the Register of Independent Entrepreneurs
- the record of any trade mark registration or licences relating to their use by the licensor at the Trade Mark Registry
- the address of the bank branches which it uses (limited to 5 bank branches)
- the date of the establishment of the business its history the history of its network and all information necessary to assess its business and its management's experience. This may be

limited to the preceding 5 years

- a description of the market in general and the local market and the prospects for its development
- the following details of the network:
  - a list of franchisees
  - their addresses
  - the dates of signature and renewal of agreements

This may be limited to the 50 franchisees closest to the location proposed for the prospective franchisee

- if applicable the catchment area or territory of the proposed franchisee and other franchised (licenced) establishments which are in the same area
- a description of the term of the contract and conditions for renewal, termination, assignment and exclusivity
- a description of the nature and amount of expenses and capital investment.

Non compliance is a criminal offence. The franchisee also has a range of remedies under the Civil Code.

## **Indonesia**

The Indonesia Government issued a regulation on franchising on 18 June 1997. The basic law provides a framework for pre-contract disclosure and for registration of new agreements as well as existing agreements; the former within 30 days from the date of the agreement and in the latter case within six months from the date of the regulation. Failure to register results in the revocation of the franchisee's business licence.

The implementing regulation provides more detail of the required pre-contract disclosure which must be truthful and in writing and provide information about:

- the franchisor and its business activities
- the IP rights
- the franchisee's obligations
- the franchisor's support

- the respective rights and obligations of the parties
- termination cancellation and renewal of the contract

There are other non pre-disclosure requirements

- priority has to be given to local sourcing of products and services
- the franchisor has an obligation to nurture, guide and train the franchisee
- a sub-franchisor is required to operate at least one unit

There is a peculiar provision which while permitting pan Indonesian development restricts implementation to stages with account to be taken of social and economic development in the framework of the development of small and medium sized business. The Minister of Industry and Trade will stipulate implementation provisions after consultation with the minister and heads of relevant government agencies.

## **Italy**

So far in Italy there is no law directly focussed on franchising. Bills have been laid before parliament but whether they will become law and if so whether the Bills will be changed is unknown.

The first Bill is the one on which I shall briefly comment was introduced on 2 March 1997.

The draft is in two parts - the first part is an explanation of the reasoning behind the Bill the second part contains the substantive provisions. Part one seeks to explain franchising without quite succeeding which is all the more worrying since part two does not offer any definition as a foundation for the regulations.

Examples without comments of some of the proposals include:

- the franchisor must have carried out experiments in the market for a minimum period of one year using a proper formula with at least one pilot unit
- the franchisor must own valid and uncontested legal rights to the exclusive use of the commercial marks

- the European Code of Ethics must be incorporated in the contract - the Operations Manual is an integral part of the contract.
- the agreement must be for a term (not less than 3 years) sufficient to allow amortization of the investment
- an assumption that exclusivity of territory is essential
- the contract must have a post term non-compete charge for at least 3 years after termination
- know how and confidential information is protectable apparently indefinitely and the franchisee is obliged to insure that this protection extends to staff and relations even after termination
- neither party can assign the contract without the consent of the others

## **Korea**

On 7 April 1997 the Fair Trade Commission issued a notice setting out the criteria for establishing what constitute unfair trade acts in franchising under the Korean Monopoly Regulation and Fair Trade Act.

The approach is different from those so far described. The basic principle is based upon the assertion that the nature of franchising requires a franchisor to make available the data and information which is necessary to enable a prospective franchisor to make an informed decision about whether or not to take up a franchise. Anything which a franchisor may do which may necessarily interfere with the franchisee's activities in its franchised business must be disclosed by the franchisor.

The disclosure information is based upon one party taking unfair advantage of the other as provided in the Monopoly Regulation and Fair Trade Act. There is a list of the sort of conduct which would offend in terms of disclosure. The list comprises four items, three of which curiously are dependant on the prospective franchisee making a written request for information with which the franchisor does not comply. This suggests that if the prospective franchisee does not ask, the franchisor

does not have to do anything.

The only conduct which does not require a request requires the franchisor to provide information relating to costs and fees, including franchise fees, security deposit money and other public fiscal obligations or not allowing the prospective franchisee sufficient time to review the data provided, the agreement and any annexures to it.

Information to be provided on request includes:

- the business history during the previous 5 years and financial and financial statements relating to the franchisor's business
- providing further information regarding the agreement because the prospective franchisee has difficulty in understanding certain provisions
- details of the status of the shop and it seems profit forecasts are to be assessed because the prospective franchisee has difficulty in understanding such matters

There are other provisions relating to equipment and product purchasing obligations; the failure of the franchisor to continue with the franchise ceasing to provide goods and/or services; imposing a new financial burden on the franchisee; the unilateral amendment of the agreement and the imposition of post termination restraints on competition without justification.

## **Mexico**

Franchise disclosure was introduced in June 1991 and implemented by a regulation coming into effect on 8 December 1994. The law also requires registration at the Mexican Institute of Industrial Property apparently for trademark purposes

There are ten headings under which information has to be given:

1. the franchisors name, domicile and nationality
2. a description of the franchise
3. how long the franchisor has run the business?

4. details of any relevant copyright
5. the nature and amount of payments to be made by the franchisee
6. the nature and extent of services and technical support to be provided by the franchisor
7. a description of the franchisee's territory
8. whether or not the franchisee has the right to sub-franchise and if so on what basis
9. the franchisee's obligations to maintain confidentiality
10. a general statement of the franchisee's rights and obligations

## **Spain**

The basic law was enacted on 5 January, 1996 and depends for its detail on a regulation whose publication is still awaited.

The basic law requires that 20 days before a contract is signed or money paid by the franchisee to the franchisor that the franchisor must provide the franchisee in writing with all information regarding the franchise network will be obliged of enabling the franchisee to be in a position to decide freely and knowingly whether or not to enter into the contract. The basic law lists the following heads of information required

- essential identification regarding the franchise
- a description of the market
- the exploitation structure and extension of the networks
- the essential provisions in the franchise agreement

## **USA**

The United States has both federal and state laws which directly affect franchising. What follows is a brief introduction to what is a complex web of legal requirements.

At the federal level there is a precontract disclosure requirement created under statutory authority by the Federal Trade Commission. The rule applies throughout the states except where state laws are more restrictive. The North American Securities Administrators Association has devised a Uniform Franchise Offering Circular (UFOC) to enable a standard for-



mat to be used which complies with both federal and state disclosure laws. There are a variety of state legal requirements the most stringent of which are those which require registration of the franchise offering as well as the delivery of a pre-contract disclosure document. Some require disclosure but not registration; some have neither regulation nor disclosure.

The following is a brief list of the information which has to be included in the UFOC.

- the identity of the franchisor, its trade name and trade marks
- the business experience of the franchisor's, directors and officers
- the franchisor's business experience
- the franchisor's litigation history (to include that of its Directors and Executives) Litigation covers criminal civil and administrative procedures
- the bankruptcy history of Directors and Executors
- a description of the franchise
- initial funds required to be paid by a franchisee
- details of persons affiliated with the franchisor with whom the franchisee is required or recommended to do business
- obligations to purchase
- revenues received by the franchisor in consideration of purchases by a franchisee
- financing arrangements
- restrictions imposed on the franchisee in regard to sales
- personal participation required by the franchisee in the operations of the franchise
- termination cancellation and renewal of the franchise
- statistical information concerning the number of franchisees and company owned outlets
- site selection
- training programme
- public figure involvement in the franchise
- financial information concerning the franchisor

There are no private rights to enforce compliance with the FTC rule - the FTC are the enforcement agency and can apply for (among other things) injunctions to prevent continued non compliance

The state laws provide franchisees with remedies which include the right to rescind and claim damages.

## **Russia**

Russia does not have a disclosure law - it does have a registration requirement but its law does not explain how one should register the agreement or what is the purpose of registration.

The fact that Russia has a law relating to franchising is an oddity since there is not a lot of franchising in Russia. This is a case where the law has come before the commercial practice and it contains provisions which many franchisors will regard as discouraging. The law was adopted as Chapter 54 of the Russian Civil Code on 22 December 1995 by the State Duma and approved by the Federation Council on 25 January 1996. It is at the time of writing somewhat early to judge the effect of the law and how it will be enforced.

The law is woven with ideas and concepts and demonstrate the difficulties the legislators had in coming to an understanding of franchising and master franchising.

A few examples of provisions in the code include:

- the franchisee has a right to renew the contract on expiry of the term on the same terms as those contained in the original contract - if the franchisor refuses to renew it cannot enter into a similar contract covering the same territory for a period of three years
- the franchisee (and the franchisor for that matter) has the right at any time to terminate on six months notice if the contract has no fixed term
- in the event of the death of the franchisor (presumably this only applies to private individuals) his heir automatically succeeds provided he has registered as an entrepreneur within six months. If he does not take up the role within the six

months then a manager appointed by a notary public takes over are during that period. If the heir does not become registered as an entrepreneur the contract is terminated

- there are provisions relating to the liability of the franchisor for acts or defaults of the sub-franchisor or sub-franchisee.

The worrying trend which is emerging is that recent legislation particularly in Indonesia, Korea and Russia shows significant signs that those introducing the legislation do not have a sufficient understanding of the subject. The draft bills in Italy, which has a sufficiently significant franchise community to know better, could be very damaging for continued franchise development in Italy.

Hopefully the study which UNIDROIT (International institute for the Unification of Private Law) will be publishing in 1998 will provide the understanding of franchising, particularly cross border franchising, which will enable greater levels of understanding to be achieved.

We now turn to the second category of regulations which impacts franchising in some way or other without being specifically focussed on franchising. Some examples have been referred to in Chapter 3 such as the Commercial Agents Law in Dubai which is interpreted so widely that it applies to non agency transactions regardless of whether the parties intended to be principal and agent. As explained above, the French Loi Doubin applies not only to franchising but all licences of trade marks with exclusivity or quasi exclusivity. Another law in some countries which often affects franchise systems is aimed at trading schemes which have more than one tier e.g. franchisor, sub-franchisor, sub-franchisee. This law is aimed at pyramid selling, multi level marketing and network marketing; some of which systems are fundamentally founded on fraud. The way these laws are structured often catches franchise systems. In the UK the original legislation of this nature was contained in the Fair Trading Act 1973 but that Act was recently

amended by the Trading Schemes Act 1996 which had a change of emphasis. Under this Act virtually all trading relationships i.e. distribution systems, agency franchising as well as the "pyramid etc. schemes" and have to comply with regulations unless they come within one of the two exemptions. These exemptions are:-

- single tier systems
- non single tier systems provided all participants are at all times registered for VAT

The legislation is unhappily wide and the regulations are clearly only drafted with pyramid type schemes in mind which means that many businesses affected cannot make sense out of complying with the regulations. Certainly franchise systems could not do so.

There are also dangers lurking for franchisors who impose controls in their agreements which are inconsistent with the franchisee's status as an independent contractor. There are jurisdictions in which the courts have held that what was intended as a franchise agreement was in reality a contract of employment.

There are also potential problems in some countries where the courts have applied consumer protection laws to business transactions - and therefore also franchise agreements e.g. the German standard terms contracts law.

Chapter 3 which deals with the legal audit must be taken seriously - there are many hidden pitfalls in many connections - your investigations must be wide. Fortunately the would be cross border franchisor is better placed than his predecessors since there is now more published information as well as those with the experience to provide guidance.

APPENDIX A

## **Horwath Franchising Services**

HORWATH Franchising Services was formed as the joint venture vehicle to give effect to the agreement between Horwath International and Eversheds to establish a global franchise consultancy. The company builds upon the extensive Horwath International consultancy network and Eversheds extensive international franchising practice and clientele with its worldwide network of lawyers.

Both organisations were conscious of the difficulties which franchise clients were experiencing in identifying qualified, ethical consultants as they travel the world with their franchise systems.

Horwath franchising consultants are all trained and on-line to a support desk, and experience and information is shared to the benefit of clients.

In addition to the consultancy services the company has developed a franchise register. The purpose of the register is to identify franchisors seeking international contacts and businesses looking for franchise opportunities so that they can be put in touch with each other. The cost is set at a modest level and only charged if a deal results.

APPENDIX B

## **Horwath International**

HORWATH International is one of the world's largest international networks of accounting and management consulting firms with offices in more than 90 countries around the world.

Horwath's member and correspondent firms, with 400 offices and 14,000 partners and staff across the globe, offer a broad spectrum of professional services, including accounting, auditing, tax and consulting. Horwath's member firms have earned a worldwide reputation as advisers to the travel and tourism industry, family and owner-managed businesses, professional service firms, as well as in franchise consulting, information technology, and international tax structuring and tax planning.

Each member is an established leader in its national or regional business community, and is staffed by nationals. This guarantees a knowledge of local laws and customs, which is important to clients undertaking new ventures or expanding into other countries.

While each member firm assumes responsibility for its professional services, common operating standards for international projects have been developed, and assignments are monitored continuously through a system of quality controls. This assures that each member firm is able to meet the high standards of practice and commitment to client service that Horwath International has established.

APPENDIX C

## **Eversheds**

EVERSHEDS London is the City of London headquarters of the UK's leading national law firm. The office has 70 partners and 230 other lawyers, many of whom are the leading players in their fields, providing a full range of services to the business community. Our approach is to provide commercial and practical advice with local access to national resources, and a commitment to innovation and improvement.

In every legal discipline in which businesses require advice, Eversheds not only has the resources but, in many, specialists who are regarded by their peers in the profession as among the leaders in their field. We are credited in both the *Legal 500* and *Chambers & Partners* directories as one of the pre-eminent firms with leading individual practitioners in such areas as construction, environment, employment, franchising and insurance.

Our reputation is flourishing. As we continue to attract star players to the Eversheds team, so we continue to solve legal issues for clients in every sector with service based on the highest technical standards and care. In particular, our franchising team and practice are one of the largest in the world.

Eversheds London is more than simply a City firm. We are able to draw on the resources of one of the largest practices in the country - and the second largest in Europe - to ensure a flexible and imaginative approach to solving legal dilemmas. Clients reap the benefits of consulting the largest property and litigation practices, and the third largest company commercial practice in the UK.

Our size is matched by our strength and experience: we have

over 100 UK publicly-quoted clients, including some of the country's fastest-growing companies. The August 1997 edition of the *Hambro Company Guide* lists Eversheds as one of the country's top four law firms in its league table of both stock market and fastest-growing clients. The *Sunday Times* (January 1998) ranked Eversheds as number one in the UK for the number of venture capital deals and number one in the UK for the number of deals generally.

Eversheds' resources comprise over 1,400 lawyers, based in 18 offices in the UK and overseas. To deliver this service, we operate specialist teams of lawyers covering more than 30 areas of law and diverse industry sectors.







### *The Author*



**Martin Mendelsohn** has been a leading figure in franchising for more than 35 years. He is a partner at Eversheds, one of the country's leading legal firms and Chairman of its National Franchise Group. He is Visiting Professor of Franchise Management at the Middlesex University Business School, London.

Mendelsohn is legal consultant to the British Franchise Association. He has advised governments about franchising under the aegis of OECD, ILO, UNDP and the UK Know How Fund.

He is the author of *Franchising, The Guide to Franchising, How to Evaluate a Franchise* and *How to Franchise Your Business* (co-authored with David Acheson) and editor of the quarterly publication, *The International Journal of Franchising & Distribution Law* and *Franchising in Europe*. He also writes regularly in *Franchise World*. His works have been published in ten languages.

Mendelsohn is the architect of the BFA arbitration scheme for franchisees introduced in 1987, and the author of the BFA guide *The Ethics of Franchising*.

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**Horwath International**  
415 Madison Avenue, New York, NY, 10017, U.S.A



**EVERSHEDS**

**Eversheds**  
Senator House, 85 Queen Victoria Street, London EC4V 4JL

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